The Economist

JANUARY 24TH–30TH 2009

www.economist.com

Inside the banks

A 14-PAGE SPECIAL REPORT ON THE FUTURE OF FINANCE



Home
This week's print edition
Daily news analysis
Opinion
All opinion
Leaders
Letters to the Editor
Blogs
Columns
KAL's cartoons
Correspondent's diary
Economist debates
World politics
All world politics
Politics this week
International
United States
The Americas
Asia
Middle East and Africa
Europe
Britain
Special reports
Business
All business
Business this week
Management
Business education
Finance and economics
All finance and economics
Economics focus
Economics A-Z
Markets and data
All markets and data
Daily chart
Weekly indicators
World markets
Currencies
Rankings
Big Mac index
Science and technology
All science and technology
Technology Quarterly
Technology Monitor
Books and arts
All books and arts
Style guide
People
People
Obituaries
Diversions
Audio and video
Audio and video library
Audio edition
The World In
The World in 2009
The World in 2008
The World in 2007
The World in 2006
The World in 2005
The World in 2004
Research tools
All research tools
Articles by subject
Backgrounders
Economics A-Z
Special reports
Style guide
Country briefings
All country briefings
China
India
Brazil
United States
Russia

Print edition January 24th 2009

Inside the banks
Blank cheques, bankruptcy, nationalisation: the options are dire, but governments must choose between them: leader



...rica

...aza war
...making peace

Back to a kind of life

Israel after Gaza
Counting the cost

Iraq's elections
A real choice for the people

Correction: A war of words and images

Europe

France
A time of troubles and protest

East European economies
To the barricades

Spain's new unemployed
And worse to come

Russian political murders
Deaths in Moscow

Hesse's election
A strange liberal revival

Charlemagne
Iceland hunts the euro

Britain

Rescuing banks
Shorn bank shares, shaven poll ratings, shredded nerves

Robert Burns
Selling Scotland by the verse

The return of Ken Clarke
The beast is awake

Public-service broadcasting
When just one BBC is not enough

Private education
Rock or hard place?

The police
A new beat

Regulating alternative medicine
But does it work?

Bagehot
An unaffordable luxury

Articles flagged with this icon are printed only in the British edition of *The Economist*

International

Terrorism
The growing, and mysterious, irrelevance of al-Qaeda

NATO
Who can unite the allies?

Development
Fairly happy birthday

Public health
So near, yet so far

Charles Darwin
A natural selection

Central Africa
Bloody history, unhappy future

Carla Del Ponte
Madame Prosecutor

Profits and charity
How to be bold

Paul Dirac
Theoretical physics

Sundance film festival
Underwater treasures

Obituary

Gaston Lenôtre

Economic and Financial Indicators

Overview

Output, prices and jobs

The Economist commodity-price index

Gold production

Trade, exchange rates, budget balances and interest rates

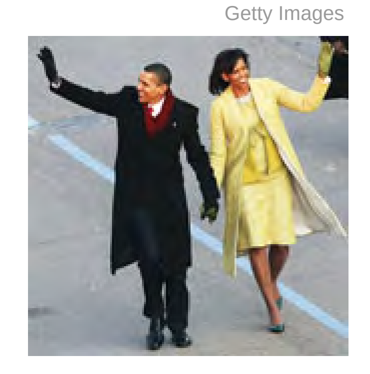
Markets

Big Mac index

Politics this week

Jan 22nd 2009
From The Economist print edition

Getty Images



Barack Obama was inaugurated as America's 44th president, becoming the first black man to hold the office. With the country in recession, Mr Obama delivered a sombre speech from the steps of the Capitol building to a throng of people on the National Mall. He spoke of reaching out to the Muslim world and also to tyrants who were "willing to unclench [their] fist". The White House proclaimed it "a national day of renewal and reconciliation".

The only mishap was Mr Obama's actual swearing in, when both he and the chief justice of the Supreme Court, John Roberts, tripped over their words. The next day at the White House Mr Obama took the **presidential oath** for a second time "out of an abundance of caution", according to a spokesman.

Mr Obama took the first steps towards closing the prison at **Guantánamo Bay**. Proceedings in the case of five men accused of plotting the September 11th 2001 attacks, including Khalid Sheikh Mohammed, the self-confessed mastermind, were immediately suspended. See article

Caroline Kennedy decided not to seek the Senate seat for New York vacated by Hillary Clinton. John Kennedy's daughter was considered a shoo-in when she said she would like the appointment, but some Democratic activists questioned her experience.

Transport-safety investigators began examining data recovered from a jet that had to ditch in the **Hudson river** soon after taking off from New York's LaGuardia airport on January 15th. All the passengers and crew were rescued from the aeroplane, which lay partly submerged in icy waters. The pilot was praised for his skill in manoeuvring the aircraft down without any loss of life.

Still in the Arena

A legislative election in **El Salvador** saw the left-wing FMLN party winning the largest share of the vote but failing to win an absolute majority in the Congress. The ruling conservative Arena party wrested the mayoralty of San Salvador, the capital, from the FMLN. The result pointed to a close race in a presidential election due in March.

In another blow to the rule of law in **Nicaragua**, the Supreme Court quashed a 20-year jail sentence for corruption against Arnoldo Alemán, a former president, freeing him from house arrest. The opposition claims that the court is controlled by supporters of Mr Alemán and his ally, Daniel Ortega, the current president.

In **Canada**, two men who are leaders of a breakaway Mormon sect appeared in court in British Columbia on charges relating to their practice of polygamy. See article

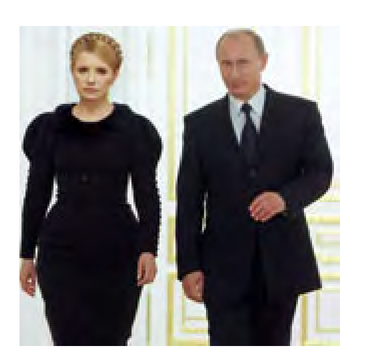
Putting the gas back on

AFP

After a squabble lasting almost three weeks, **Russia** belatedly restored gas supplies to Europe via pipelines in **Ukraine**. The two countries' prime ministers, Vladimir Putin and Yulia Tymoshenko, signed a formal agreement in Moscow on gas prices and direct sales.

A leading **Russian** human-rights lawyer, Stanislav Markelov, was shot dead in Moscow, along with a journalist. Mr Markelov had represented a Chechen family, one of whose members was raped and murdered by a Russian officer in 2000. The Kremlin made no comment on the murders. See article

Prosecutors in **the Netherlands** said they would put on trial a Dutch member of parliament, Geert Wilders, on charges of making anti-Islamic statements. Mr Wilders, who last year released a film, “Fitna”, which attacked the Koran, said it was a black day for freedom of speech.



Spain and **Portugal** were both downgraded by Standard & Poor’s, a credit-rating agency, following an earlier downgrade for Greece. Other European countries may be downgraded as their economies enter recession and budget deficits balloon. See article

Exit strategy

Israel declared a unilateral ceasefire in the Gaza Strip on January 18th; the Islamist **Palestinian** group, Hamas, followed suit soon after. Some 1,300 Palestinians and 13 Israelis are reckoned to have been killed in three weeks of fighting. An array of foreign governments sought to help secure the ceasefire and, once again, to press for talks that might lead to a wider peace. On his first day in office Barack Obama phoned Mahmoud Abbas, the Palestinian president, and Ehud Olmert, Israel’s prime minister, as well as Egypt’s president, Hosni Mubarak, and King Abdullah of Jordan. See article

At least 2,000 **Rwandan** troops crossed the border into **Congo** to prepare for a combined operation with the Congolese army against Hutu guerrillas whom the Rwandans accuse of complicity in genocide against Tutsis in their country in 1994. Aid agencies fear that thousands more civilian deaths and displacements could occur if the operation goes ahead.

The monarch and the pen

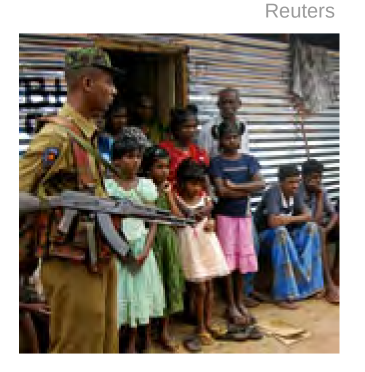
An Australian resident of **Thailand**, Harry Nicolaides, was sentenced to three years in jail for defaming the Thai royal family. The charges related to passages in a little-read self-published novel. His is one of several *lèse-majesté* cases being pursued by officials. See article

Thailand’s prime minister, Abhisit Vejjajiva, promised a full investigation of allegations that Thai armed forces had intercepted nearly a thousand boat people and sent them out to sea in boats with little food and no engines. Most of the boat people were **Rohingyas**, members of a Muslim minority, many of whom had already fled Myanmar once, for Bangladesh. See article

Taiwan’s former president, Chen Shui-bian, pleaded innocent in court to charges of corruption. He claims he is a victim of political persecution by the ruling party, which defeated him at last year’s election. His case was dealt a blow when three members of his family pleaded guilty to money-laundering. See article

The **Sri Lankan army** said it had designated a “safe zone” for civilians as it presses ahead with its offensive against the rebel Liberation Tigers of Tamil Eelam in the north of the country. Some 250,000 people are estimated to have been displaced by the fighting.

Reuters



Britain’s foreign secretary, David Miliband, offended **India’s** government on a visit to the country by linking the attack in Mumbai last November to the issue of Kashmir. In what was seen as a symbolic gesture towards Pakistan, India testfired a BrahMos cruise missile. It missed its target. See article

Business this week

Jan 22nd 2009
From The Economist print edition

Citigroup confirmed a big shake-up in its corporate structure as it reported a net loss for the fourth quarter of $8.3 billion. Speculation mounted that it would soon offload Nikko Cordial Securities, its Japanese broking unit, which it bought only a year ago. As part of its shake-up Citi named **Richard Parsons**, Time Warner's former boss, as its new chairman, replacing Sir Win Bischoff.

It emerged that the American government provided **Bank of America** with an extra $20 billion in funding to help smooth its acquisition of Merrill Lynch. BOA also recorded a $1.8 billion quarterly loss, its first in 17 years. In a show of confidence Kenneth Lewis, the bank's chief executive, and five directors bought more than 513,000 shares in the company, which had the immediate effect of reversing a swift decline in its share price.

Britain's government took more measures to shore up its battered banking system. It plans to guarantee top-rated asset-backed securities and to limit the potential losses on banks' toxic assets, for a fee. The Bank of England was given the power to buy up to £50 billion ($68 billion) of company debt. See article

Denmark extended DKr100 billion ($18 billion) in aid to its banks; the plan is voluntary. And the share prices of **Irish banks** tumbled as investors fretted that the government's nationalisation of Anglo Irish Bank would not be the last.

A startling performance

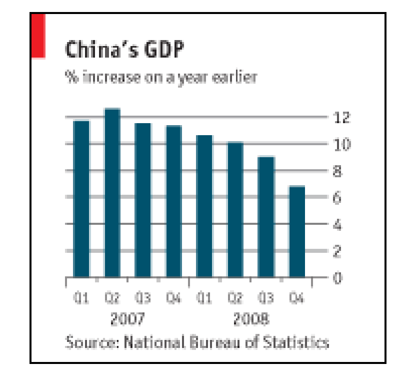
Royal Bank of Scotland's share price fell by 67% after it forecast an annual loss of up to £8 billion ($11 billion) and a goodwill-impairment charge of up to £20 billion; Gordon Brown said RBS had acted irresponsibly. The share prices of other big financial companies also took a nosedive in response to the latest round of bad news from the banking industry and the Dow Jones Industrial Average closed below 8,000 for the first time since late November. See article

A downcast technology sector was cheered when **Apple** and **IBM** reported healthy rises in quarterly profits. **EBay** didn't fare so well, posting its first year-on-year decline in revenue.

Brazil's central bank reduced interest rates by a full percentage point to 12.75%. The cut was larger than expected.

Steadily losing its puff

China's GDP growth fell to 6.8% in the year to the fourth quarter, the slowest pace for seven years. China's economy grew by 9% for the whole year, a sharp fall from a 13% growth rate in 2007, when China pushed past Germany to become the world's third-largest economy. The government forecast a "very grim" outlook for jobs and said it would try to ease the slowdown; workers have been protesting in large numbers at job losses. See article



The European Union's competition commissioner launched another complaint against **Microsoft**, this time accusing the software giant of "tying" Internet Explorer, its web browser, to Windows and so hampering its rivals. The objection comes despite Internet Explorer's rapid loss of a sizeable portion of the web-browser market to Mozilla's Firefox and Apple's Safari. In 2007 Microsoft dropped its appeal against huge fines that the EU levied for "bundling" its music player with Windows and for withholding information from rivals that allows their software to "interoperate" with Windows over a network.

Saddled with lots of debt and a credit line that expires in May, the **New York Times Company** tapped

Carlos Slim, a Mexican telecoms mogul and one of the world's richest men, for a $250m loan, on which it will pay 14% interest. Mr Slim has recently accumulated a stake of almost 7% in the Gray Lady's publisher.

London's leading daily newspaper, the *Evening Standard*, was sold for a "nominal sum" (thought to be £1) to **Alexander Lebedev**, a Russian oligarch and former KGB agent who was based once in the city.

The Italian job

Fiat forged a strategic alliance with **Chrysler**. The Italian carmaker will take a 35% stake in the troubled Detroit company in return for access to its small-engine and transmission technology and international dealerships. The deal throws a lifeline to Chrysler, which risks having to repay an emergency $4 billion loan to the federal government and losing the chance of further help if it cannot provide evidence of a credible turnaround plan. See article

Toyota appointed Akio Toyoda, grandson of the company's founder, as its new boss. The Japanese carmaker is expected to make its first-ever operating loss in the year to March. In one bright spot, Toyota said it sold 8.97m cars last year, beating **General Motors'** tally of 8.35m and thus becoming the world's biggest carmaker, a title GM has held for 77 years.

KAL's cartoon

Jan 22nd 2009
From The Economist print edition

Illustration by KAL






The future of finance

Inside the banks

Jan 22nd 2009
From The Economist print edition

Blank cheques, bankruptcy, nationalisation: the options are dire, but governments must choose between them

Illustration by Derek Bacon



“STARTING today,” President Barack Obama declared in his inaugural address from the Capitol, “we must pick ourselves up, dust ourselves off, and begin again the work of remaking America.” In fact his first, urgent task is to remake finance. As Mr Obama spoke in Washington, DC, the markets in New York were sinking under the weight of failing banks despite the promise of a plan from his economic team. A day earlier Britain had put forward its second attempt to get its banks to lend. Others, such as Germany and Italy, may before long need to step in; France, Ireland and Denmark already have.

The crisis has shown up flaws in financial markets and the global economy. Huge flows of capital into debtor nations like America and Britain pumped up asset markets (see article). These fed the instabilities of financial markets—which, as our special report explains in this issue, were themselves plagued by poor regulation, dangerous incentives and the reckless use of mathematical models. Fixing this will take a lot of work over the next 18 months or so, when legislation should be ready, but already a picture of a new finance is becoming clearer: smaller, better regulated, more conservative.

That vision is worth keeping an eye on, but the immediate priority is the imperilled banking system. Just now, with finance in ruins, the nexus of markets and non-banks that make up the “shadow banking system” has failed. Decent businesses are being starved of credit and driven into bankruptcy. For their sake, and for the people who work for them, it is time to admit that the first round of bank rescues was not enough. With talk of huge public subsidies—nationalisation even—the question is what to do next?

A sinking feeling

Nothing at all is one answer. Because last year’s efforts cost hundreds of billions of dollars, some may conclude that saving the banks is wasteful and pointless. In fact the first rescue succeeded in one important respect. The excessive lending of the boom has to be brought under control. That inevitably brutal change can take place in two ways. It could be relatively orderly as borrowers scale back and lenders strengthen their balance sheets. Or it could cause a mass-panic that would wreck banks and businesses as it did in the 1930s. Just such a panic was in the air in October. Today’s recession is grave but in sparing the banks, however undeserving, governments spared their citizens from something worse—at least so far.

If a rescue makes sense, what sort? Last autumn the rescue of Britain’s banks—perhaps the sorriest in

any large economy—became a template for others. Britain is in the lead once more, but this time round its effort is likely to be remembered for all the wrong reasons. The main part of the government's new plans is to insure the banks against their worst losses on their worst assets. Nobody (not even the government) knows how much that will cost; just that Gordon Brown has once again thrown all his ideas at the problem, including the kitchen sink.

The prime minister should do his bit for the building trade and order a bigger sink. The markets were unimpressed by the scale of his effort. Shares in London fell, notably in the very banks the plan was designed to help. Sterling tumbled on fears for Britain's economy and the government's finances.

Saviour of the universe

For any government setting out a rescue, this reception holds two lessons, concerning the scale and the shape of a rescue. First, its scale must surprise everyone. Because economies everywhere are suffering from excessive fear as well as over-borrowing, part of the aim is to convince investors that the downward spiral in confidence has been broken. Britain's plans were caught in a contradiction: seeking both to save the banks, which need a staggering sum, and also to mollify voters, who (understandably) resent handing over a single penny.

Scale is important in this crisis. As the recession rips through the economy, banks are bound to face further losses. Shareholders worry that these losses will continue to eat away at the banks' reserves. Back in October governments' promises to save the banks stabilised markets. But in this topsy-turvy crisis these promises are now pressing down on banks' share prices. If a bank looks about to suffer large losses, investors fear nationalisation is imminent—and head for the exit.

And that leads to the second broad lesson from Britain: the design of a rescue matters and history shows that it is hard to get right (see article). One possibility is government guarantees and insurance. Another is to take the hit up front, by putting the toxic assets into a "bad bank" that acts as a *cordon sanitaire*. And a third, which has been gaining traction of late, is outright nationalisation.

Each of the three has its strengths. Guarantees can quickly swing into action and the assets remain with managers who know most about them. Bad banks create a clean break that enables the good bank left behind to get on with the real job of raising capital and lending it out. Even nationalisation has something to say for it. Gone are the difficulties of valuing assets and of the bank's shareholders plotting to grab taxpayers' money—because the government is on both sides of the deal. Expect to hear that argument a lot more over the coming months, not just in Europe but also in America.

As a capitalist newspaper, we reject a deliberate policy of wholesale nationalisation. To be sure, state ownership may make some sense as a tactic for specific financial institutions. We argued for it with both Fannie Mae and Freddie Mac in the United States and with Northern Rock in Britain long before politicians in either country succumbed to the inevitable. Like it or not, it may be the least bad option in many cases ahead. But the difficulties are legion. Unless nationalisation takes place at market prices, it undermines property rights and raises the long-term cost of capital. And even if expropriation is avoided, there are difficulties. Although nationalised banks could increase the supply of credit by restoring confidence, their record at allocating it is even worse than private banks'. If the idea is state-directed lending, the banks will waste a fortune and kill enterprise. If the plan is to offer the banks a brief shelter in a storm, it looks fanciful. Large bank privatisations are unlikely for several years.

But what of the other two options—bad banks and insurance? Britain chose insurance alone and, at the moment, it looks as if it has made a mistake. The suspicion is that the government preferred insurance for political reasons because it is a promise-now, pay-later scheme. It would have done better to reach for that kitchen sink and do both—buy the worst assets at their market value and put them in a bad bank, as well as insure the healthy assets that remain against catastrophe. With a clean start, the remaining good banks would be able to raise capital. The idea would be to examine each bank on its merits, cleaning it out, partially insuring its remaining risks, and recapitalising it with government equity where necessary. At some banks that might leave the government as the biggest shareholder, as the British government is at the Royal Bank of Scotland, or the sole owner, as at Northern Rock. In such cases nationalisation is not an end in itself, but a consequence of the policy that most rapidly returns the banking system to health. It is a heavy cost, but there is no alternative. If taxpayers own a bank, pretending that they don't only exacerbates the harm.

This crisis is so huge that seeing beyond it is hard. Yet even now policymakers need to plan for the future

of finance—partly to convince voters that today's rescue is preparing for a better system; partly because finance's shortcomings and the taxpayers' guarantees make an overhaul of regulation necessary; and partly because sensible reforms are hard to devise.

Having seen finance wreak havoc, the temptation will be to bind it in a regulatory straitjacket. Some tighter regulation is in order, especially if it is aimed at making the system more transparent. But this crisis was born of economic excess as well as financial folly; given the torrent of capital flowing into America, Britain, Spain and so on, almost any financial system would have gone wrong. Financial re-regulation is not the only reform—it may not even be the most important. Yet finance makes the rest of the economy work. Mr Obama's prize for remaking finance will be measured in prosperity and jobs. The work should begin now.

Yes you must

Jan 22nd 2009
From The Economist print edition

Phenomenon Obama is now President Obama: he and his supporters should prepare for a long haul

Reuters



IT WAS a tough speech for tough times. Barack Obama's inauguration was a sobering, bitingly cold morning of reflection, not the joyful celebration that the inauguration of the first black president would have prompted in less desperate circumstances. And by calling for sacrifice and maturity after the long enjoyment of "childish things", Mr Obama showed a grasp of the magnitude of the task ahead and also started to rein in the more messianic expectations of his supporters.

Not before time. In the past, Mr Obama has been a bit too prone to play to the zealots who surround him. As he clinched the nomination, he announced "this was the moment when the rise of the oceans began to slow and our planet began to heal." Even as he stood on the west steps of the Capitol, he was still not entirely immune from this temptation—promising the nearly 2m people before him solutions to failing schools, poor health care, lost jobs and even saying (rather awkwardly) that he would "roll back the spectre of a warming planet".

Can he really do all this? Can President Obama, a man who will have to compromise and haggle, really live up to Phenomenon Obama, that mythical cipher for so many dreams? No. But he knows it—and, even if it was not his best speech, it was a useful start in expectations-management. He did not quite offer nothing but blood, toil, tears and sweat; nor did he instruct his listeners to ask what they could do for their country. But he did compare the current crisis to the bleakest winter of the Republic's history, when George Washington's battered army lay at bay at Valley Forge, and he announced an end to "putting off unpleasant decisions".

Now he must put that philosophy into action. For instance, there was a coded pledge to embark on entitlement reform, pruning back the costly programmes that will bankrupt the government if left unattended. There is a bargain to be struck, binding the promised short-term economic stimulus to longer-term reform of America's pension and health-care policies. But he needs to make that deal more explicit—and to start bullying Congress soon.

One small step on Guantánamo

Even on matters more uniquely within the chief executive's control, Mr Obama will find himself constrained. He would have liked to announce the closure of the prison camp at Guantánamo on his first day in office. But that proved hugely problematic. Mr Bush had been trying for over two years to do it—though allies, seeking to earn credit with the new administration, may now be readier to take in some of those detainees unable to go home but cleared for release through tighter judicial oversight. Mr Obama

requested a 120-day halt to the operation of military tribunals and, as *The Economist* went to press, there was talk of an executive order to close Guantánamo within a year.

That may seem a long time to wait, and it will add to the list of disappointments for those who had hoped for immediate transformation. (Already there is mounting frustration among some of Mr Obama's staunchest supporters—see article). But that is the way democracies work. The trick is to bind the fiddly immediate business of reform to a bolder vision.

Mr Obama did that this week with human rights. With a stony-faced George Bush sitting behind him as he spoke, Mr Obama denounced the notion that America had to choose between its safety and its liberal ideals (including the rule of law). Correcting the mistakes and abuses of Guantánamo, not to mention Abu Ghraib and other hellish places, and reaffirming America's commitment to those ideals, comes not a moment too soon for America's friends, including this newspaper. But delivering on these promises and—lest anyone forget—the still tougher economic ones will be a slow and halting process.

After the Gaza war

Peace now?

Jan 22nd 2009
From The Economist print edition

At the very least, this is not a bad time to start serious work

AFP



FRANCE'S president, Nicolas Sarkozy, has a reputation for letting his enthusiasm run away with him. Having rushed with other European heads of government to the Middle East to douse the flames of Gaza, he returned home with a characteristically grandiose idea. Now that a truce seems to be taking hold, he wants, "within weeks", to convene a peace conference to begin solving the whole conflict once and for all.

Impetuosity can be a dangerous thing in diplomacy. One reason for the failure of Israel and the Palestinians to make peace at Camp David in 2000 was a lack of adequate preparation by Bill Clinton. And Mr Sarkozy would certainly be a fool to rush in before co-ordinating any proposal with Barack Obama. But the French president's main insight is correct: the aftermath of the Gaza war is as good a moment as any—and maybe even better than many—to breathe new urgency into broader peacemaking in the Middle East.

This is because nothing focuses minds faster than a war. Gaza is only the latest bloody reminder that when this particular conflict is left to smoulder, it tends to ignite with a bang, the reverberations of which travel far beyond Palestine itself. The anger on the Arab street has shaken pro-American Arab regimes such as Egypt's and will hinder Mr Obama's efforts to open a friendlier chapter in America's relations with Islam.

All of this strengthens the case for Mr Obama to do what he has promised and tackle the Arab-Israeli conflict right away. There is, however, an argument against. This holds that the present circumstances are in fact all wrong. When Mr Clinton was president, the Palestinians still had what they used to call a sole, legitimate representative in the person of Yasser Arafat, who said he accepted the permanence of Israel. How can diplomacy work now that the Palestinians are split between Fatah in the West Bank and, in Gaza, the Islamists of Hamas who say they reject the very idea of peace with a Jewish state?

The answer to this excellent question is not to put diplomacy on hold. Nor is it to pretend, as George Bush did, that Fatah can make peace with Israel as though Hamas did not exist. Instead, American, European and Arab diplomacy should now join forces to mend the Palestinian schism. The peacemakers are not without tools. Hamas held a hollow "victory" parade this week (see article), but Israel's rampage through Gaza's streets and skies may have reduced the allure of "armed struggle" in the eyes of both the movement's leaders and its followers. The right mixture of pressure and inducements, including an end to Gaza's economic blockade, might well tempt Hamas back into a unity government, not least because it stands a fair chance of controlling such a government when next there are elections in both Gaza and the West Bank.

The test of the settlements

Would it be a disaster if Hamas won? Only if it stood by its rejectionist creed. Yet Fatah too once called for the destruction of Israel, and changed its mind. Hamas even now sends out enough hints of pragmatism to make it worth seeing whether it can be induced to undertake a similar ideological journey. But—and here is the other immediate job for the peacemakers—Hamas will not be induced to compromise unless the prospect of a Palestinian state begins to look real. To that end, Mr Obama needs to make it clear, preferably before Israel's election next month, that America will no longer countenance Israel's colonisation of the West Bank. The Jewish settlements there should never have been built, and Israel has promised to freeze them. This has become a test. If Mr Obama cannot hold Israel to its promise, his chances of restoring America's standing as the indispensable mediator in this conflict are nil.

Ex-communist reform

Mass murder and the market

Jan 22nd 2009
From The Economist print edition

Economic reform in Russia was accompanied by millions of early deaths. But it was not the cause



MATCHES and even salt were in short supply as the Soviet empire's planned economies collapsed two decades ago. But blame was plentiful then and now. Millions of people—chiefly men in late middle age—died earlier than their counterparts in other countries. That drop, of fully five years in male life expectancy between 1991 and 1994, demands explanation. A newly published article in the *Lancet*, a British medical journal that in recent years has used epidemiological analysis to examine political and social questions, argues that the clear culprit was mass privatisation (distributing vouchers that could be swapped for shares in state-owned enterprises). A statistical analysis, it says, shows that this element of the economic-reform package, nicknamed "shock therapy", clearly correlates with higher mortality rates.

That, says the *Lancet*, was a shocking failure. It argues that advocates of free-market economics (it cites an article in this newspaper by the economist Jeffrey Sachs) ignored the human costs of the policies they were promoting. These included unemployment and human misery, leading to early death. In effect, mass privatisation was mass murder. Had Russia adopted more gradual reforms, those lives would have been saved.

In fact the blame game must start at the beginning. Why was the Soviet economy in ruins by 1991? Partly because planned economies don't work (blame Lenin and Stalin for that). Partly because the gerontocratic leadership of Leonid Brezhnev failed to start reforms in the early 1970s, when gradualism might have had a chance of succeeding. By the time Mikhail Gorbachev initiated *perestroika* and *glasnost* in the late 1980s, the Soviet Union was all but bust. Worse, by running the printing presses red-hot, his government created a colossal monetary overhang. Russians may have thought that their savings evaporated when prices were liberalised at the start of 1992; in truth, their cash was already worthless.

Surgical alcohol

The second question is the effect of all this on mortality. Soviet public-health statistics show a clear decline from 1965 to the early 1980s, with rising deaths from circulatory diseases (because of poor diet, smoking and, especially, drinking). Mr Gorbachev's anti-booze campaign—although hugely unpopular—raised life expectancy by fully three years between 1985 and 1987. After 1992 the state monopoly on alcohol (and health checks on its quality) collapsed. As anybody who lived in Russia at the time will recall, the effect was spectacular—and catastrophic. Death rates returned to their long-term trend.

The thorniest question is about economic policy mistakes after 1991. In retrospect, the West failed to prepare for the Soviet collapse. It took too long to recognise that Boris Yeltsin's first government deserved trust, pressing it too hard on debt repayments and being too stingy with aid. Then it made the opposite mistake, being too trusting and generous when Russia was becoming more hawkish and looting was endemic. Mass privatisation broke the planners' grip but failed to create the hoped-for shareholder democracy.

Yet the *Lancet* paper seriously misunderstands both the timing and the effects of economic reform. It states quite wrongly that "Russia fully implemented shock therapy by 1994". As it happens, in that year life expectancy started rising. But in any case reforms were by then bogged down and advisers such as Mr Sachs had quit in despair. Moreover, mass privatisation had little immediate effect on jobs—or much

else. Most Russians exchanged their vouchers for trivial amounts of cash, or even vodka. That may have been marginally bad for their health—but it does not explain the huge jump in the death rate.

Correlation is not causation. Mass privatisation was not the most important or effective part of “shock therapy” and the rise in death rates is out of synch with efforts at economic reform. Furthermore, countries that successfully applied shock therapy, such as Poland, saw improved life expectancy. So did the then Czechoslovakia, which plumped for mass privatisation, albeit not very successfully. Mistakes were made, but Russia’s tragedy was that reform came too slowly, not too fast.

Space travel

Mars rising?

Jan 22nd 2009
From The Economist print edition

Why NASA should give up its ambitions to send men into space

Illustration by Claudio Munoz



AS LONG as people have looked up at the night sky, they have wondered whether humanity is alone in the universe. Of places close enough for people to visit, Mars is the only one that anybody seriously thinks might support life. The recent confirmation of a five-year-old finding that there is methane in the Martian atmosphere has therefore excited the hopes of exobiologists—particularly as the sources of three large plumes of the gas now seem to have been located. These sources are probably geological but they might, just, prove to be biological.

The possibility of life on Mars is too thrilling for mankind to ignore. But how should we explore such questions—with men, or machines? Since America is the biggest spender in space, its approach will heavily influence the world's. George Bush's administration strongly supported manned exploration, but the new administration is likely to have different priorities—and so it should.

Bug-eyed monsters

Michael Griffin, the boss of American's National Aeronautics and Space Administration (NASA), a physicist and aerospace engineer who supported Mr Bush's plan to return to the moon and then push on to Mars, has gone. Mr Obama's transition team had already been asking difficult questions of NASA, in particular about the cost of scrapping parts of the successor to the ageing and obsolete space shuttles that now form America's manned space programme. That successor system is also designed to return humans to the moon by 2020, as a stepping stone to visiting Mars. Meanwhile, Mr Obama's administration is wondering about spending more money on lots of new satellites designed to look down at the Earth, rather than outward into space.

These are sensible priorities. In space travel, as in politics, domestic policy should usually trump grandiose foreign adventures. Moreover, cash is short and space travel costly. Yet it would be a shame if man were to give up exploring celestial bodies, especially if there is a possibility of meeting life forms—even ones as lowly as microbes—as a result.

Luckily, technology means that man can explore both the moon and Mars more fully without going there himself. Robots are better and cheaper than they have ever been. They can work tirelessly for years, beaming back data and images, and returning samples to Earth. They can also be made sterile, which germ-infested humans, who risk spreading disease around the solar system, cannot.

Humanity, some will argue, is driven by a yearning to boldly go to places far beyond its crowded corner

of the universe. If so, private efforts will surely carry people into space (though whether they should be allowed to, given the risk of contaminating distant ecosystems, is worth considering). In the meantime, Mr Obama’s promise in his inauguration speech to “restore science to its rightful place” sounds like good news for the sort of curiosity-driven research that will allow us to find out whether those plumes of gas are signs of life.



OPINION
LETTERS

On the sea, evolutionary psychology, health care, Plato, Africa, economics

Jan 22nd 2009
From The Economist print edition

Fish stew

SIR – Your special report on the sea ("Troubled waters", January 3rd) outlined the escalating problems caused by overfishing. But simply improving the allocation of quotas, as you urge, amounts to rearranging the deck chairs on the *Titanic*. Marine protected-areas can't work if habitats have lost the capacity to provide fish with food and shelter. Long-term solutions lie in tackling global warming, rising sea levels, pollution and overharvesting; in the short term we can nurse back devastated ecosystems into economically productive habitats. In Indonesia, for instance, 95% of the coral reefs have ecologically collapsed.

With the help of Indonesian community-based groups we are using low-voltage electricity to develop solid limestone reefs that reverse acidification in the surrounding sea. Those reefs attract huge numbers of juvenile fish and brightly coloured corals quickly grow back in devastated areas where no natural recovery has taken place, restoring fisheries and creating valuable ecotourism.

Subsistence fishermen in developing countries know they are destroying their children's future. They would gladly adopt more productive and less destructive techniques, but lack the training, technology and investment that are given freely to industrial fishing fleets.

Thomas Goreau
President
Global Coral Reef Alliance
Cambridge, Massachusetts

SIR – You believe that it is inefficient to harvest fish that must themselves be fed because "it takes at least three kilos of fish meal to add one kilo to the weight of a farmed salmon." Actually, salmon convert their feed very efficiently and it takes only 1.2 kilos of feed to produce one kilo of salmon. I think your error crept in because producing one kilo of fish meal (which makes up just a third of salmon feed) takes 4.5 kilos of fish by-products. Around 25% of the world's fish meal comes from by-products such as fish guts, heads and tails. The other 75% comes from whole small, bony fishes, such as anchovy and menhaden, that do not make for good eating. It is important that these are cropped sustainably, but given the correct control measures, the conversion of 1.5 kilos of small undesirable fish into one kilo of highly valued salmon is a fair trade-off.

Andrew Jackson
Technical director
International Fishmeal and Fish Oil Organisation
St Albans, Hertfordshire

SIR – Greenland's ice sheet has an average depth of three kilometres, lies mostly undisturbed, and predates climatic periods much warmer than the present. Therefore, your assertion that its ice sheet, "is on course to melt completely" makes about as much sense as the belief, common until very recently, that property prices would rise indefinitely.

Robin Glass
Oak Bay, Canada

SIR – You quoted a nautical John Kennedy at the start of your report: "All of us have in our veins the exact same percentage of salt in our blood that exists in the ocean." In fact, the salt concentration of seawater is about 3.48% and in blood the value is roughly 0.98%. Most fish (but perhaps not sharks and rays) are thought to have evolved in freshwater. It's a nice image, but the science is wanting.

James Gould
Professor
Ecology and evolutionary biology
Princeton University
Princeton, New Jersey

Science and evolution

SIR – I noticed that the line of reasoning in *The Economist*'s take on evolution has not got any better ("Why we are, as we are", December 20th). Everything is ex-post reasoning: we can run fast, detect cheating, kill our stepchildren, because…and here you simply insert anything from the days of being a member of a small, close-knit, endangered tribe to justify this.

With this, one can explain almost everything without actually ever bothering or being able to prove anything. In addition, the classical fallacy of *post hoc ergo propter hoc* cannot be ruled out: evolutionary psychologists arguing from how we behave, to guess why we behave as we do.

And anyway, so what? Surely to know thyself is the beginning of wisdom, but the analysis of social issues eventually leads to applicable solutions. Evolutionary psychology is mute here; it has to be because otherwise social Darwinism is lurking dangerously close.

The Economist has a penchant for looking at life in a Darwinian way, and I very often enjoy this. But bad psychology does not get better by repeating it.

Konrad Obermann
Professor Mannheim Institute of Public Health
University of Heidelberg
Mannheim, Germany

A healthy argument

SIR – Michael Moore's claim that Cuba has a better health-care system than the United States is not as "ridiculous" as you think ("Health screen", January 10th). The United States was ranked 37th in the latest report on health care from the World Health Organisation, whereas Cuba ranked 39th. I suspect there is little difference between being placed 37th and 39th. However, when productivity is factored in Cuba's health-care system does indeed seem to be more effective than America's. America spends 15% of GDP on health care (which works out at $6,700 per person in 2006 dollars) while Cuba spends 8% ($360 per person). Most businesses would consider themselves better than their competitors if they delivered an equivalent product or service at one-twentieth the cost.

Kenneth McLeod
Chair
Department of bioengineering
Binghamton University
Binghamton, New York

The philosophy of numbers

SIR – Your article on numbers presented psychological evidence that humans are born with an innate sense of counting ("Easy as 1, 2, 3", January 3rd). You then claimed that this evidence contradicts Plato's theory about how our knowledge of numbers is acquired. Strictly speaking this is not true for Plato (though some Platonists might beg to differ). Although Plato did think that "numbers…existed in some abstract, eternal and perfect realm", he did not believe that "mortals were granted only an occasional glimpse" of them.

Plato's "Meno" Socratic dialogue has Socrates famously purporting to show that a slave boy has innate knowledge of geometry; he believed that our knowledge of geometric facts (and, it seems reasonable to suppose, of numerical ones) comes from our acquaintance with the realm of abstract objects prior to the embodiment of our souls. He also thought that instruction and contact with the world were only

necessary for our recollection of this knowledge.

Brent Kious
Los Angeles

The not-so-dark continent

SIR – I am deeply saddened and apoplectic with rage at your article on Ghana's election ("A damned close-run thing—and a fine example to the rest of Africa", January 10th). It seems you have decided to submit a positive story about Africa with an upbeat message. Would you kindly refrain from such liberties and return to your standard doom-and-gloom analysis of a continent that you usually write off as useless and in dire need of paternalist assistance (if only we were enlightened enough to accept it).

Disgusted of Nairobi
Nairobi

The following letters appear online only

More fish food for thought

SIR – I appreciated your leader on industries that operate in the sea ("A sea of troubles", January 3rd). A lack of political focus, bad management, overfishing and other forms of excessive use of marine resources are indeed detrimental to a sustainable future for the sea. The European Commission has given warning about the need for sound management of the already depleted fisheries resources and is raising awareness about the urgency of adapting to the impact of climate change in maritime and coastal areas. Better and more comprehensive maritime governance is needed if we are to address the critical situation of the world's oceans and seas.

The commission is working with the European Union's member states to address the overall management of the oceans, rather than sector by sector. Many crosscutting initiatives have been launched, including a road map to develop maritime spatial planning in Europe, a European marine and maritime research strategy, efforts to establish a maritime surveillance network in Europe, the promotion of offshore wind energy, recommendations for integrated maritime governance structures and a proposal for an EU policy for the Arctic.

Nathalie Charbonneau
Spokeswoman for fisheries and maritime affairs
European Commission
Brussels

SIR – The EU needs to take fisheries conservation more seriously. The commission's most recent estimate of fishing-fleet overcapacity is outdated. At the same time most EU countries fail to comply with the requirement to assess the state of their fleet capacity in relation to the available fishing opportunities. As a result, the commission is charged with managing something it cannot currently measure.

The review of the Common Fisheries Policy is the single greatest opportunity in Europe to design regulations that allow fish stocks and the wider marine environment to recover while guaranteeing long-term socio-economic benefits. This can only happen if the related challenges of overcapacity and illegal fishing are tackled.

Uta Bellion
Director
EU Marine Programme of the Pew Environment Group
Brussels

SIR – Your criticisms of the fishing industry were biased. Why, for example, didn't you mention that arguments over susceptibility to diseases, the (controlled) use of antibiotics, the (inevitable) production of faeces, the production of (some) carbon and energy use are normal in traditional land-based farming, too.

Consumers prefer fish that are predators, with their high protein levels. The key for their successful cultivation is to feed them with vegetable proteins enriched with marine proteins. This makes environmental and economic sense, and turns aquaculture into a net producer of fish protein.

Javier Ojeda
General manager
Spanish Fish Farmers Association
Chiclana, Spain

Economic highs and lows

SIR – You noted that the prevailing mood at this year's gathering of the American Economic Association was one of "despair, not hope" (Economics focus, January 10th). The "mood" of economists has been cyclical throughout history. At the onset of the Depression, Irving Fisher thought that everything was fine and lost his reputation and a fortune in the downturn. When the second world war was coming to an end, Alvin Hansen forwarded the stagnation thesis, and underconsumption theories were floating around. No disaster happened and the economy grew, leading to an overconfidence reflected in the president's economic report during the administrations of John Kennedy and Lyndon Johnson.

When expansionist policies resulted in stagflation and the Bretton Woods system collapsed, there was talk of "limits to growth". The Reagan-Thatcher revolution changed this and economists decided that the market could take care of everything, "greed was good" and the sky's the limit. Now that we have financial and economic problems it is not surprising the mood has turned sour.

Kamran Dadkhah
Associate professor of economics
Northeastern University
Boston

Norway and the environment

Binge and purge

Jan 22nd 2009 | OSLO
From The Economist print edition

Home to a green-minded people and government, Norway exports the dirty stuff to the rest of the world. The result is a contradiction

AFP



ON THE shores of a glittering fjord, in the shadow of craggy mountains, right at the heart of Norway, stands a new factory belonging to a firm called NorSun. Inside, blond technicians in goggles tease metres-long crystals out of vats of liquid silicon and slice them into the thinnest of wafers, to be used in solar panels. The power for the factory is as pristine as the surroundings: it comes from a nearby hydroelectric plant. “It’s a nice idea,” says Cecilie Holst, one of the employees, “making solar panels with clean energy.”

That is how Norwegians like to think of themselves—as good custodians of the environment, who are helping to move the planet towards a greener future. And so they are in many respects: 98-99% of Norway’s electricity comes from hydroelectric plants. It was one of the first countries to adopt a carbon tax in an attempt to slow global warming, back in 1991. It was also the first country to capture carbon dioxide and store it underground. Making that process easier and cheaper is Norway’s “Apollo mission”, says the prime minister, Jens Stoltenberg. His centre-left coalition government has pledged to make the country carbon neutral by 2030, bringing forward its previous deadline of 2050. Meanwhile, Norway promises to be a “driving force” for a new international treaty on climate change to replace the Kyoto protocol, which expires in 2012.

Yet for all its environmental piety, Norway is also a prodigious polluter. Its greenhouse-gas emissions have grown 15% since it adopted the carbon tax. They are still rising, and are likely to continue to do so until 2012, according to Mr Stoltenberg. As it is, Norway spews out more emissions per head than many other countries in Europe. And, in the eyes of many environmentalists, these statistics understate the damage Norway is doing to the atmosphere. It is the world’s third-biggest exporter of gas and fourth-biggest exporter of oil. The process of extracting these fuels from below the North Sea releases some greenhouse gases within Norway itself. But when the oil and gas Norway exports are burned abroad, they generate far more emissions.

When the government says Norway will be carbon neutral by 2030, it is taking only domestic emissions into account, not the much larger amount embedded in its hydrocarbon exports. By contrast, it does intend to count emissions cuts it has paid for overseas towards the goal of carbon neutrality. Those offsets will be paid for in part with revenue from oil and gas. In short, Norway is profiting handsomely at the planet’s expense, while spending a small share of the proceeds on projects to reverse a fraction of the damage done.

All this is the subject of far-reaching political debate in Norway. Some think the country should be doing much more to fight global warming. There are calls to limit new exploration for oil and gas, and so to reduce hydrocarbon exports. Mr Stoltenberg says his government has no intention of doing that. In fact, it is opening up new areas to exploration and development. But that is not enough for Norway's biggest opposition group, the populist Progress Party: it thinks that the government should spend less time and money on symbolic green goals, and should cut petrol taxes and build more roads instead.

All this may sound like a small squall in a narrow fjord. But as more and more countries aim for ambitious emissions targets, they are likely to face similar conundrums. How green is enough? How much carbon is too much? At what point do offsets become a cop-out? As Norway's experience shows—it was also the first country to see a government collapse amid a row about global warming, in 2000—there are no easy answers to these questions.

It is hard to overstate the extent to which greenery has penetrated official thinking in Norway. Successive governments have taken all the obvious steps. There are high taxes on petrol and cars. There is an extensive public-transport system, with trains between the big cities, ferries along the coast and buses that call at many of Norway's remote hamlets. There are cycle routes galore, and not as many new roads as drivers would like. In fact, the government is so keen to reduce road traffic that it has said it will double funding for public transport for cities that promise to squeeze private vehicles off the roads.

Even though nearly all Norway's power comes from hydroelectric plants, the government is also trying to promote other forms of renewable energy and energy efficiency. It has tightened energy-efficiency standards for buildings. It is encouraging firms and homeowners to burn wood and other forms of biomass for heat and power, instead of fossil fuels. It has set up a fund of 10 billion kroner ($1.4 billion) to invest in renewable-power and energy-efficiency projects; Mr Stoltenberg said last year that he would double the money on offer this year. The government has also set up another, similar outfit to try to advance carbon capture and storage. A third agency, due to start work some time this year, will look for ways to reduce emissions from transport.

Over the bridge, into the tunnel

Norway's bureaucrats spend a lot of time pondering thorny climate-related questions. The Highway Department, for example, has looked into the relative environmental merits of different sorts of fjord-crossings. Bridges, it turns out, are superior to tunnels, since vehicles consume less petrol driving across them than they do descending the steep gradients into tunnels and climbing back out on the other side. What is more, tunnels need power for lights and ventilation fans, and to run pumps when they flood, whereas bridges require almost none. So it is now official policy to prefer bridges to tunnels.

The reverse is true when crossing mountains: the extra emissions associated with digging a tunnel are quickly offset by the petrol saved by the cars whizzing through them, instead of winding their way up and down the steep slopes above. Norway boasts the world's longest road tunnel: a 25km (16-mile) tube punctuated by the occasional blue-lit cavern, to give weary drivers the impression that they are emerging from the gloom, if only fleetingly.

State-owned firms have also been drafted into the quest to reduce Norway's emissions. Statkraft, Norway's biggest power company, which is entirely state-owned, has several different renewable-power projects under way. It hopes to develop a floating wind turbine, which it believes would be cheaper to build and install than current offshore models, embedded in the sea floor. That would also allow turbines to be used in deep waters in the open ocean, where the wind is often stronger and steadier.

But Statkraft's most ambitious project involves an exotic new technology called salt power. This involves tapping both freshwater and seawater at the mouths of Norway's many rivers and fjords, and diverting it to tanks on either side of a semi-permeable membrane. The freshwater is drawn across the membrane to dilute the saltwater, and so helps to build up pressure on that side of the tank. The pressurised water can then be used to turn a turbine to generate electricity.

Statkraft reckons it could eventually provide 10% of Norway's demand for power in this way. It has spent ten years and 100m kroner developing the technology. It has managed to increase the power it generates per square metre of membrane from less than one watt to three, and hopes eventually to reach five. Late last year it started up a pilot plant on the waterfront south of Oslo. But the power it produces is still far from competitive.

StatoilHydro, the partly state-owned firm that is Norway's biggest oil and gas producer, also has several climate-friendly projects under way. It, too, for example, is developing a floating wind turbine. It plans to install the first full-scale test model towards the end of this year. And it is participating with the government in a scheme to capture and store emissions from a gas-fired power plant—a world first.

To encourage more of that sort of thing, the government levies a carbon tax on Norway's dirtiest industries. Oil and gas firms, the main target, responded as intended, by enormously increasing their efficiency. On average, oil firms emit 7.8kg of carbon dioxide for every barrel they produce in Norway, compared to a global average of 19kg, according to StatoilHydro. It calculates its own emissions at just 7kg a barrel, or 37% of the global average.

To trim its emissions, StatoilHydro has greatly reduced the flaring of natural gas. It also runs two of the world's four big carbon-capture schemes. These involve filtering out the carbon dioxide that is found along with the natural gas from two of its fields, and pumping it back underground at great expense. It is also experimenting with running cables from the mainland to its offshore platforms, to allow them to run off cleaner mains power, rather than small gas-fired generators.

But StatoilHydro's output has grown so much in recent years that its emissions have risen too, despite these advances. So the government is now trying a new tactic: a cap-and-trade scheme. It has set an overall limit on emissions, and has issued a corresponding number of permits to pollute to firms covered by the scheme. Those that exceed their allocation must either cut their emissions or buy spare permits from other participants.

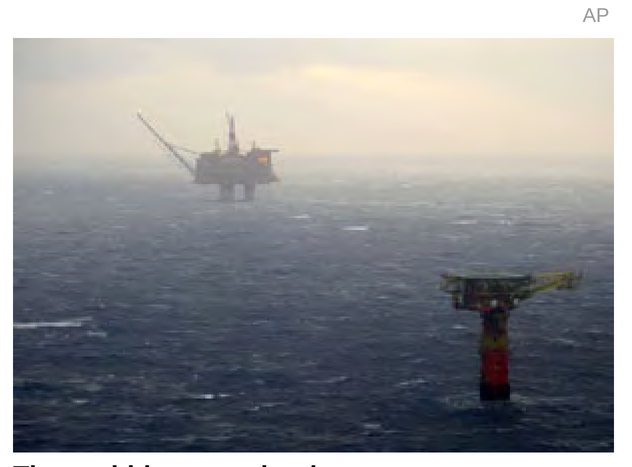
In theory, this system is more watertight than a tax, since the overall level of emissions is fixed. But the government has linked its carbon-trading scheme to that of the European Union, giving Norwegian firms access to a much larger pool of spare permits. That will lower the costs of compliance, but it also means that the desired emissions cuts may take place in Spain or Slovakia instead of Norway. The government also allows firms to pay for emissions-reduction schemes in poor countries in lieu of cutting their own emissions.

Wriggling round the awkwardness

Such offsets are the most controversial part of Norway's emissions-cutting drive. It is not just firms that use them—the government is the biggest enthusiast. Norway currently emits about 55m tonnes of carbon dioxide equivalent a year, and the government projects that on their current trajectory emissions will reach 59m tonnes by 2020. Yet it has pledged to reduce its emissions to 35m tonnes by then, and to nothing by 2030. It has identified 10m-13m tonnes-worth of cuts that could be made at home at a reasonable cost. But until new technologies, such as carbon capture or electric vehicles, become competitive, Norway's remaining emissions will not be eliminated—they will simply be offset.

The government reckons it can plant enough trees at home to offset 3m tonnes or so. That should allow it to keep its promise to make at least half of the emissions cuts it has scheduled by 2020 at home. But it still means that as much as half of Norway's notional reduction in emissions will come from overseas. And without big technological advances, Norway will be even more reliant on foreign offsets to fulfil its goal of carbon neutrality.

AP



The grubbiness under the waves

The government says it will buy only the most copper-bottomed of offsets. These should help development in poor countries as well as the atmosphere. They also advance Norway's goal of securing a replacement to the Kyoto protocol, by giving poor countries more of a stake in the process. Moreover, in addition to Norway's purchases of offsets, the government has promised to spend 3 billion kroner a year to slow tropical deforestation. If reducing deforestation is as cheap a way to cut emissions as Nicholas Stern and other climate experts think, then that money alone would be sufficient to offset all Norway's emissions twice over, Mr Stoltenberg points out.

Setting an example?

Anyway, Mr Stoltenberg argues, the obvious alternative to offsets—reducing Norway's emissions by producing less oil and gas—would be counterproductive, since it would push up prices of those fuels and so encourage consumers to switch to cheaper but dirtier alternatives, such as coal. But Rasmus Hansson, of WWF-Norway, disagrees. He thinks Norway should set an example by producing less oil and gas in the hope that other countries respond in equally high-minded fashion. "Somebody has to put on the brakes," he says. "If Norway doesn't, who will?"

The government's enthusiasm for oil and gas certainly seems at odds with its extreme punctiliousness about the morality of its other investments. The fund in which the Norwegian state stashes unspent revenue from oil and gas has exacting procedures to ensure it does not invest in firms involved in anything nasty, from human-rights abuses to environmental depravity. It sold its shares in Rio Tinto, the world's second-biggest mining firm, for fear that a mine in which it owns a stake might have caused "severe environmental damage" in Indonesia. The fund also eschews Wal-Mart, a big American retailer, because of its hostility to unions. Yet such scruples seem to go out of the window when it comes to globe-warming oil and gas.

Needless to say, Norway is making huge sums from the export of those fuels. The government estimates its 2008 revenue from the petroleum sector at 413 billion kroner. The oil-revenue fund is the second-biggest of its kind in the world, with a value of 2.1 trillion kroner at the end of September.

All that money, in Mr Hansson's view, could be put towards more aggressive pursuit of low-carbon technology. If the government spent more on offshore wind, salt power and the like, he argues, Norway could substitute exports of clean energy for the harmful sort it currently peddles. Its territorial waters are windy enough, he calculates, to generate 10,000 times the country's own power needs.

Mr Hansson also believes that ordinary Norwegians should live greener lives. Norway has the second-highest income per person in the world, over $100,000 in 2008. That has enabled many Norwegians to embrace quite lavish lifestyles, involving frequent overseas trips, second homes, big cars and perhaps a boat or a snowmobile. They are as prodigal with heating, Mr Hansson claims, as Americans are with petrol. He thinks Norwegians should use their oil wealth to tighten their belts in carbon terms, rather than bingeing.

Yet if anything, Norwegians are moving away from environmental self-denial. A recent rise in petrol tax, of 0.05 kroner per litre, caused a political storm. Many drivers, especially around congested Oslo, are also incensed by the government's reluctance to build more roads. And there is a growing sense that the government is tying itself in knots in its efforts to square its green ideals with the grubby reality of Norway's hydrocarbon wealth.

The Progress Party, which has the support of roughly a quarter of the electorate, has seized on these complaints. Ketil Solvik Olsen, its spokesman on the environment, points out lots of inconsistencies in the government's stance. Why should Norwegian drivers or air passengers pay many times more in carbon taxes than it would cost to offset their emissions? Why is the government spending so much to develop the technology to capture emissions from gas-fired power plants when what the world needs most is carbon-capture at coal-fired plants? Why is Mr Stoltenberg so anxious to stop Norwegians using gas for heating and cooking, and yet happy for Britons to do so? To celebrate the opening of a new gas pipeline to Britain, he even dropped in on an ordinary British customer for a cup of tea heated up with Norwegian gas, Mr Solvik Olsen points out, just the sort of thing the government frowns on in Norway.

Populist anti-greenery

All in all, Mr Solvik Olsen argues, the government is too ambitious and too hung up on symbolism. He wants less talk of lunar landings, and more analysis of costs and benefits. And he does not think Norwegian industry can be expected to make many more cuts in emissions. It is already very efficient, he points out, so there are few easy improvements to be made. Instead of limiting the use of offsets, the government should be expanding it.

So far, the half-dozen other parties in parliament have ignored the Progress Party's concerns and signed up to the government's strategy on global warming (indeed these parties prefer not to collaborate with the populist Progress MPs). But Progress is already the second-biggest party in parliament, after the Labour Party, which Mr Stoltenberg leads. Several polls last year even put it ahead of Labour. Mr Stoltenberg himself first came to power in 2000, when parliament rebelled against the previous prime minister's uncompromising greenery. It is not easy being an environmental pioneer.

Barack Obama's inauguration

And now to work

Jan 22nd 2009 | WASHINGTON, DC
From The Economist print edition

Getty Images



So much joy, such high expectations. Welcome to the White House, Mr Obama

EVERY inauguration has its quirks. George Washington, in his first inaugural speech, said he was not up to the job but would do his best, adding that there was no need to pay him a salary. William Henry Harrison gave the longest speech of any American president, forcing his audience to endure an hour and 45 minutes of snow-chilled tedium. He died a month later. Abraham Lincoln was sworn in by the chief justice who wrote the worst Supreme Court decision of all time, which upheld slavery and deemed black people eternally inferior.

Barack Obama's inauguration was marked by global jubilation and stratospheric expectations. (It was also slightly marred by a bumbled oath-taking, which Mr Obama corrected—though he did not need to—in the White House the next day.) More people probably packed the Mall than at any previous event in Washington—nearly 2m, by one estimate. More people probably watched his speech on television than any previous president's, partly because the world's population has grown, but partly because Mr Obama has charmed people from Kenya to Karachi.

His supporters rose before dawn and waited hours in icy weather to catch a glimpse of the new president. They wept, cheered and sang "This Land is Your Land" and "Hit the Road, George". They clapped furiously, though the sound was muffled by thick gloves. Headline-writers struggled to find synonyms for "historic". Adulation spilled over onto Mr Obama's wife, Michelle. "All Hail the Leader of the Fashionable World", trumpeted the *Washington Post*, commenting on her outfit.

The message of Mr Obama's speech on January 20th was sombre. America is in crisis, he said. The nation is at war. The economy is badly weakened. Health care is too costly, American schools fail too many, and "each day brings further evidence that the ways we use energy strengthen our adversaries and threaten our planet." As if that were not grim enough, there is "a sapping of confidence across our land—a nagging fear that America's decline is inevitable, and that the next generation must lower its sights."

Without directly insulting the man sitting behind him, Mr Obama alluded early and often to his predecessor's faults. The woeful state of the economy, he said, is "a consequence of greed and irresponsibility on the part of some". In other words, the suits on Wall Street gambled the country into penury and George Bush failed to stop them. American ideals, such as the rule of law, "still light the

world, and we will not give them up for expedience's sake". Unlike some former presidents he could mention. "Our power alone cannot protect us, nor does it entitle us to do as we please." And, of course: "We will restore science to its rightful place."

Half-borrowing a theme from Shakespeare, he spoke of "this winter of our hardship". But whereas Shakespeare's winter was swiftly turned into "glorious summer" by a new king, Mr Obama gave warning that the immediate future for Americans will be tough. Life will be all about braving icy currents and enduring raging storms, fortified only "with hope and virtue". He promised "bold and swift" action to revive the economy: building roads and bridges, electric grids and digital lines. "We will…wield technology's wonders to raise health care's quality and lower its cost. We will harness the sun and the winds and the soil to fuel our cars and run our factories."

None of this, he said, would happen quickly or easily. The road ahead was not for the faint-hearted, or "for those who prefer leisure over work". Quoting St Paul, he declared that: "The time has come to set aside childish things." Some observers guessed this might refer to Americans' habit of living beyond their means and demanding that their government do likewise. He vowed not to postpone unpleasant decisions. When government programmes failed, he said, he would end them. But he postponed the unpleasant decision of which specific programmes he had in mind.

Can he deliver? Mr Obama ran on a platform of having cake and eating it. Those who attended his rallies came away convinced that he was offering them lower taxes, better health care and cheaper, cleaner energy, all paid for by somebody else. That was not exactly what he promised, but that was what people heard. His inauguration speech was a veiled warning not to take his campaign hype at face value.

Few people minded. Short of sacking Joe Biden and making the temporarily wheelchair-bound Dick Cheney his vice-president, Mr Obama could have said nearly anything and still made his audience faint with ecstasy. For many, the thrill of the moment lay not in what he said, but in who he was.

No other majority-white country has elected a black leader. Roughly two-thirds of African-Americans now believe that Martin Luther King's dream has been fulfilled—a proportion that has doubled in less than a year, a CNN poll says. In his speech, Mr Obama did not mention his colour. He did not need to. The whole world could see his face. He alluded to it only in passing: "[A] man whose father less than 60 years ago might not have been served at a local restaurant can now stand before you to take a most sacred oath."

The two preachers who spoke at the inauguration put it more forcefully. Rick Warren, a young white conservative megapastor, declared, "Dr King and a great cloud of witnesses are shouting in heaven." Eighty-seven-year-old Joseph Lowery, who worked arm-in-arm with King while he was still on earth, gave a folksier benediction. "Lord," he said, "we ask you to help us work for that day when black will not be asked to get in [the] back, when brown can stick around, when yellow will be mellow, when the red man can get ahead, man—and when white will embrace what is right." The crowd laughed tenderly.

The mood in Washington was unshakably jolly. Grumpy Republicans left town, stayed indoors or decided to give the new president the benefit of the doubt. Democrats, who are a huge majority in the capital and were reinforced by countless busloads of like-minded political pilgrims, whooped it up without cease. Most could not see their hero in the flesh, but were content to watch him on enormous screens. Some got stuck in overcrowded side streets and could not even see the screens, but managed with oral accounts. Some perched on portable lavatories to get a better view. Hardly anyone shoved; hardly anyone grew impatient.

Some booed the outgoing president, but their anger was blunted by the knowledge that they would not have to put up with him any more. After the ceremony, Mr Bush flew off in a helicopter. The crowds did not know which helicopter he was in, so they waved and shouted "Bye-bye, George" at any chopper that passed over them. On Monday, not far from the Mall, someone erected a big blow-up Bush with a Pinocchio nose. Revellers threw shoes at it.

The work begins

Mr Bush relinquished power without drama. Whereas Bill Clinton pardoned 140 people in his last few days in office, including a dodgy financier whose ex-wife donated to the Democrats, Mr Bush granted no last-minute pardons at all. His only late act of clemency, announced on January 19th, was to commute the jail sentences of two former Border-Patrol agents convicted of shooting a drug-smuggler on the Mexican

border.

Whether or not Americans heed Mr Obama's call for "a new era of responsibility", he himself has suddenly assumed responsibilities unlike anything he has shouldered before. Even before the inauguration parties ended, he threw himself into his new job. One of his first acts was to put on hold all regulations issued by Mr Bush that have not yet gone into effect.

On January 20th he requested that legal proceedings against inmates at Guantánamo Bay be suspended, pending a review of the system for trying suspected terrorists there. Judges in individual cases are not obliged to grant his request, but probably will. Other executive orders expected soon include lifting Mr Bush's curb on federal funding for stem-cell research, revoking the ban on aid to foreign family-planning groups that offer abortions, and tightening the ban on torture.

On January 21st Mr Obama saw his economic advisers. Congressional leaders hope within days to send him a stimulus package to sign, probably totalling more than $800 billion. Meanwhile, the new president announced a pay freeze for senior White House staff and stricter lobbying rules. On the same day he telephoned the leaders of Israel, Egypt, Jordan and the Palestinian Authority. He promised to work with them to prolong the Israeli-Palestinian ceasefire, rebuild Gaza and block the smuggling of weapons to Hamas. He is likely to name a Middle East peace envoy soon.

Mr Obama must tackle two wars, a calamitous recession and the unexpected. Yet by a three-to-one majority, Americans are more optimistic with him in charge, according to a poll by the Associated Press. True believers put it more colourfully. At the Hawaii State Society ball on inauguration night, the consensus was that if Mr Obama can bodysurf at Sandy Beach, Oahu, where broken bones are common—and he can—he should be able to handle the presidency.

Inaugural balls

Move over, Texas

Jan 22nd 2009 | WASHINGTON, DC
From The Economist print edition

A defiant hurrah

AP


Plus Scooter the armadillo

FOR anyone who was anyone, there was only one place to be eight years ago. With a new Texan master of the White House, there was no hotter ticket in town than one for the Lone Star State's Black Tie and Boots extravaganza. More than 11,000 people shelled out $125 to be there, and tickets were changing hands on eBay for ten times that amount on the morning of the bash.

This being Texas, at least for one night, everything was bigger and better than anywhere else: 60,000 jumbo shrimps were readied, along with 7,000lb (3.2 tonnes) of beef brisket and 900 cases of spirits. A longhorn steer attended, as did an armadillo named Scooter. An oil derrick showered silver confetti on the whooping crowd.

The political fortunes of Texas have changed somewhat, but you would not have known it as this year's Black Tie and Boots ball kicked off on the last night of George Bush's presidency. The numbers were just as huge; the party was just as raucous, the country music still pounded from five separate stages, and it was still quite a fight to get your hands on a drink.

If anything, it was more Texan than ever, since the out-of-state movers and shakers and their hangers-on were saving their energies for two new hot zones. One was official: the Home States Ball, featuring both Illinois, from which Mr Obama was a senator, and Hawaii, the state in which Mr Obama grew up and where he still likes to take his holidays. The second hot ball was given by the *Huffington Post*, the liberal establishment's favourite online newspaper. It was attended by Demi Moore, Ben Affleck, Teri Hatcher, Robert De Niro and Sarah Silverman.

Look a bit deeper, though, and it was a very different Texas crowd. Oilmen and cowboys were thin on the ground, and a large proportion of the guests turned out to be from Austin, the university town that is also Texas's solidly Democratic capital. Mr Bush had attended the evening in the past, but seemed to have better things to do this time. "No way would he come here," crowed one of the new Texas aristocracy. "We're a pretty liberal crowd here tonight."

Cleaning up afterwards

Bin it

Jan 22nd 2009 | WASHINGTON, DC
From The Economist print edition

But they didn't, so sweepers swept till dawn

Getty Images


Smiles undimmed

THE presidential inauguration committee promised "the greenest inauguration in history". Barack Obama was sworn in on recycled carpet. Manure from horses in the parade was sold to local farms. And volunteers tried to pick up after revellers. A group called the Trust for the National Mall donated 12,000 translucent bags. These were "approved by the Secret Service", boasted Braden Kay, a founder of an activist group called Litter Free Inauguration, which joined with the trust to encourage people to carry out what they brought in. Nonetheless, Mr Kay said that his "instinct was that some trash would be left over".

His instinct was right. Rubbish—130 tons of it—lined the parade route in dustings and dunes, and Washington's Department of Public Works released an army of sweepers, vacuums and huge container trucks to remove it from the streets before Wednesday morning. Streets are the city's responsibility, the National Park Service cleans the Mall and householders clean pavements adjoining their property. But when the wind blows as strongly as it did on Tuesday night, those boundaries are blurred.

The city's clean-up proceeded according to a strict plan. Men armed with leaf-blowers and brooms pushed the rubbish along side-streets to three main arteries—Constitution, Independence and Pennsylvania Avenues—where it was carted off towards parts of Washington that are far from the glittering party-town of ballgowns and black ties.

Sweepers and vacuumers worked on long after the revels had ended, hindered by a Byzantine network of road-blocks and diversions; by partygoers stumbling through the streets (one gentleman in particularly good spirits tried to hitch a ride from a passing truck); by Mr Obama's party-hopping, which repeatedly brought whole blocks to a halt; by freezing cold and wind; and not least by the competing abstruse interests of varying officials, all assured of their own importance. Traffic came to a stop at a crossroads where apparently at least three different types of police were trying to determine who could tell whom to shove off (you know it's bad, groused a crew supervisor, "when the police can't get the police to move").

The rubbish itself was predictable: mostly fast-food wrappers, water bottles and polystyrene cups. But few American flags were to be seen, and no discarded images of the president.



State pension funds

The land of liabilities

Jan 22nd 2009 | CHICAGO
From The Economist print edition

Illinois typifies a looming problem

IT WAS a proud moment for Illinois this week, as the state's favourite son became president. At home, though, matters are more depressing. The impeached governor, Rod Blagojevich, has much bravado and little authority. And, like dozens of other states, Illinois faces a budget deficit. Moreover, another problem is in the offing.

The state's five pension funds are looking pasty. Illinois has $54.4 billion of unfunded pension liabilities, with just 54% of the assets it needs to pay for future promises to its workers; 80% is the proportion experts usually consider adequate. These figures, the most recent available, are from June 2008. Since then, they have probably got worse.

Other states face similar woes. A sample of 109 state pension funds lost $865 billion, about 30% of their value, between October 2007 and December 2008, according to the Centre for Retirement Research (CRR) at Boston College. In Illinois the state treasurer, Alexi Giannoulias, wants to streamline the pension funds; he hopes a bill will be ready this month or next. But the funding gap will not be filled easily. The short-term outlook is bleak in Illinois and elsewhere. Pension problems only add more uncertainty.

State and local governments' retirement plans differ greatly from those in the private sector. In 2006, according to the CRR, over 60% of private workers with a retirement plan relied on a defined-contribution scheme such as a 401(k) account. Workers bear the risks of the market; many cheer when their accounts rise, but watch in anguish as they plummet. State and local workers, however, should be more calm. In 2006 80% of them relied on defined-benefit plans, which pay a pension based on wages and years on the job. The employer, not the worker, weathers market turmoil. What is more, public pensions are often protected by a state's constitution, as in Illinois.

Before the financial collapse most states were moving towards full funding. In the CRR's sample of pension plans, about 60% had funding ratios of at least 80% in 2006. The problem then seemed to be health-care liabilities, which states usually pay for out of general revenues rather than invested trust funds. The financial mayhem, however, has put pensions back in the spotlight.

Private defined-benefit plans are under most pressure. Firms, thanks to a law passed in 2006, face strict rules for shoring up their obligations. States have more leeway, but many will have to pump more money into their pension funds to offset losses on the market. Some states have been more battered than others. The value of America's biggest pension fund, the California Public Employees' Retirement System, shrank from $253 billion at the end of 2007 to $181 billion in November 2008. Trouble descended on cities as well. Philadelphia's pension fund lost 23% of its value in 2008, according to the city's controller.

Illinois's pension funds were skimpy even before the crisis. "The big-picture problem for Illinois has nothing to do with markets," explains William Atwood, director of the state board of investments. "It has to do with policymakers' decisions to allocate money to places other than pensions." After years of starving its retirement systems, in 1995 the state adopted a plan to ensure that its ratio of assets to liabilities reached 90% by 2045. But this was scuppered by generous new benefits for workers and lax payments to the funds themselves. Meagre returns have not helped. In June 2008 the state's five pension funds had $64.7 billion in assets. At the end of October they had $50.5 billion.

Mr Giannoulias's plan would consolidate the five funds, improve their management and protect them more effectively from corruption. In the past Tony Rezko, a convicted former fund-raiser, tried to use the teachers' fund for extortion. The treasurer's plan might help the funds' performance, says Laurence Msall of the Civic Federation, a watchdog, not least because investment professionals would oversee them. However, says Mr Msall, the plan "will not solve Illinois's dramatic underfunding of its pensions". Mr

Giannoulias thinks his proposal will save up to $82m a year. The state is due to pay over $4 billion to the pension system in the next fiscal year. Illinois now faces a deficit of at least $2 billion.

Illinois could follow a few other states and pass reforms for new workers. Kentucky's changes include setting a minimum retirement age. New employees in Kansas must give a bigger share of their wages to the retirement fund. But current workers' pensions are protected by law. Past promises remain a heavy burden.

The extent to which states raise their own payments to pension funds depends on the stockmarket. Most funds value their assets over several years, so the effect of one year's dip is spread over time. Still, the CRR estimates that to return funding levels to those of 2007 by 2010, the rate of return on market assets would have to be 52% each year. To return to 2007's levels by 2013, the yearly return would have to be 18%. "Taxpayers", explains the CRR's Alicia Munnell, "will have to ante up." The main question is when, and how much.

Agricultural fairs

Mutton bustin' and manure

Jan 22nd 2009 | DENVER
From The Economist print edition

All the fun of the fair at Denver's annual stock show

AP



LEANING against the fence of a stock pen, Danielle LeDoux of Poker City Ranch waits to see if her three 1,100lb (500kg) Gelbvieh bulls can win first prize. But the results are disappointing: judged on size, uniformity and muscle mass, her beasts do not even make the top three places. Although discouraged, Ms LeDoux still hopes she can sell them, or some of them, at auction a few hours later: “We knew it would be tough this year. If I can sell a couple before going home, then I’m happy.”

A sale or two would make the long trip worth it. Ms LeDoux has brought the bulls from her north-eastern Kansas ranch to the annual National Western Stock Show in Denver, a three-week livestock fair in January at which 15,000 farm animals are shown, ranging from cattle and sheep to chickens and llamas. All are clipped, brushed and blow-dried to look their best.

Handsome as the beasts (and fowl) may look, buyers are more concerned with their powers of reproduction. Animals are bought and sold on the basis of their genetics and breeding history. Bovine perfection comes at a price: a prized nine-month-old heifer can fetch up to $80,000. Livestock sales at last year’s fair added up to roughly $8m. Those who cannot afford to buy an animal outright can purchase the genes without their owner: semen from the 2008 grand champion Angus is available for $25 per half-cubic-centimetre.

Roughly 3,000 agricultural fairs take place in America, varying in size and seriousness. Denver boasts one of the largest and oldest, held in its current form since 1906. Earlier variations were less organised: in 1898, enticed by free beer, 20,000 drunken Denverites ravaged the Bison Barbeque. Planners wondered about holding the event elsewhere. But, in the event, the show remained in Denver and nowadays draws 700,000 well-behaved visitors a year.

Tourists come for the fun. For townspeople the show offers a chance to connect with Denver’s pastoral origins. There is a “Dress Western” barbecue. Six-year-olds can compete in the Mutton Bustin’ contest, where the object is to cling to the back of a confused sheep for as long as possible. Fiddling contests are held and a mariachi band enlivens the popular Mexican Rodeo Extravaganza.

Apart from a pungent smell every January, the fair generates $80m for the local economy. “It is an important economic boost, and makes us feel uniquely Western,” says Tom Clark of the chamber of commerce. And as the animals head for home at the end of the month, they leave a parting gift for Denver’s gardeners: 14,000 cubic yards of fresh manure.

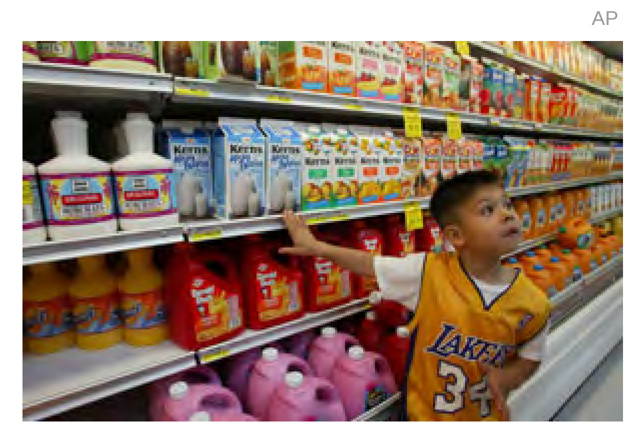
Segregation and shopping

The call of the mall

Jan 22nd 2009 | LOS ANGELES AND QUEENS
From The Economist print edition

Americans of all ethnic groups are increasingly living and going to school together. Shopping is another matter

AP



Horchata for every (Mexican) taste

IN THE H-Mart supermarket at the new Diamond Jamboree shopping centre, customers can peruse more than 60 shelf-feet (18 metres) of kimchi. A heavily Asian clientele buys seaweed, dried pollock and live catfish. A few doors down, the new 85ºC Bakery churns out the soft brioche rolls beloved by the Taiwanese—up to 700 of them every day.

A common enough sight in an inner-city ethnic ghetto, perhaps. But this is Irvine, a scrupulously tidy suburban city south of Los Angeles that is only about one-third Asian. The shopping centre is surrounded not by overcrowded tenement buildings but by light manufacturing firms. It is a new kind of ethnic community, and an extremely popular one.

Martin Luther King once described Sunday mornings, when people go to church, as the most segregated moment in American life. That is probably still true. But, particularly for groups other than blacks, Saturday mornings are not far behind. A century ago ethnic-minority groups clustered for self-defence, or because they were forced to. Half a century ago they were bound together by language and poverty. Now they congregate to eat and shop.

Despite the housing-market crash, immigrants and ethnic minorities continue to leave inner-city ghettos for more mixed suburbs. That movement has forced other changes. Research by Gary Orfield of the University of California at Los Angeles shows that in 1988 the average white public-school pupil went to a school that was 83.4% white. That proportion had fallen to 76.6% by 2006. In the West more than a fifth of white children attended mixed-race schools, with at least 10% of students from three or more ethnic groups.

Every year California's schools cope with fewer children who cannot speak English. The proportion of Los Angeles Latinos who are fluent in the language has risen from 52% to 58% since 2000, according to the Census Bureau. Some 660,000 of them (16% of the total) speak no Spanish at all. But assimilation has not eradicated differences in taste.

The Diamond Jamboree centre's customers are among the most affluent Asians in Irvine. Many of the teenagers sipping sweet iced coffee are students from the local outpost of the University of California. Women push mixed-race children in prams. Eddie Lam, whose Chinese restaurant had its grand opening this week, reports that at least four-fifths of his Asian customers order their food in English.

Much English can also be heard at Plaza Mexico, a shopping centre in south Los Angeles. There, men

photograph their children in front of ersatz Mayan fountains and what looks like a Baroque church (actually a market where you can buy shoes, basketball shirts and pet rabbits). It is an odd sight. But many of these urban Latinos have never seen a real Mexican village.

José Legaspi, who has turned several dying malls into thriving Hispanic shopping centres, says the appeal of such places goes well beyond their Mexican flourishes. The shops often have wider aisles for big family groups, as well as more entertainment for children. The sales patter is different, especially acknowledging men's pride in providing for their families. (English-speaking shoppers, by contrast, are "independent Marlboro men".)

More surprising than the rise of ethnic shopping centres outside traditional neighbourhoods is what has happened to those neighbourhoods. Most are no longer the population centres of their communities, and many now play host to other groups. Los Angeles's Koreatown is largely, and increasingly, Hispanic. Yet businesses catering to Koreans are thriving, and the district has even expanded. Suburban visitors explain how one of the poorest neighbourhoods in Los Angeles can sustain expensive shoe shops and diamond jewellers.

Or take Queens in New York. The home of the fictional bigot Archie Bunker is now one of the most ethnically diverse communities in the country. More than 140 languages are spoken there, and more than a third of the population is foreign-born. Many apartment buildings are "like the United Nations", according to Joseph Salvo of New York City's planning department. A steadily rising number of subdivisions, he says, contain no racial majority.

What seem like ethnic enclaves in Queens are often something else. Leaving the 7 subway line, the "immigrant express", at the 74th Street stop, the visitor finds himself in what appears to be a South Asian neighbourhood. There are shops selling saris and Indian jewellery, a Patel Brothers supermarket and Indian restaurants. Yet nearby flats are mostly occupied by immigrants from Central America. The shops are patronised by South Asians who travel into the neighbourhood.

Ethnic communities that are based on shopping are, of course, not nearly so monolithic as ones rooted in language and neighbourhood. Latinos also go to Gap, as well as to Asian supermarkets like 99 Ranch. And Mr Legaspi points out that another change is quietly afoot. Gradually, he says, central Americans are assimilating into the broader Hispanic culture—a process he labels "Mexicanisation".

A similar trend can be seen in Irvine's new shopping centre. The shelves in H-Mart contain Chinese, Korean and Vietnamese foods, as well as American breakfast cereal. The menu in Mr Lam's restaurant includes Vietnamese and Cambodian dishes as well as Chinese ones. The people who frequent centres like this one are not so much clinging to their parents' and grandparents' ways as creating a new culture that is both pan-Asian and American. King would probably not have objected.

Lexington

Betrayed by Obama

Jan 22nd 2009
From The Economist print edition

Some of the new president's most ardent supporters already feel let down

Illustration by KAL



ANY decision Barack Obama makes can cause a stir. He invited Rick Warren, a popular pastor, to say a few words at his inauguration. The aim was to stroke conservative Christians, thereby fostering a warm feeling of national unity. But some of Mr Obama's gay supporters were appalled. Though hardly a fire-breather by the standards of Southern Baptists, Mr Warren holds old-fashioned views about homosexuality. Bloggers lamented Mr Obama's "betrayal". Dan Savage, a gay columnist, urged his readers to protest by coining a new meaning for "Saddleback"—the name of Mr Warren's church. Many of the suggestions were unprintable. To soothe sore tempers, Mr Obama invited a gay bishop, Gene Robinson, to speak at an inaugural concert.

It has been only two-and-a-half months since Mr Obama was elected, but his "Yes, We Can" coalition is already fraying at the edges. In his appointments and pronouncements, Mr Obama keeps hinting that he is neither as radical nor as pure as his progressive supporters dared to hope. Anti-war activists, who rallied round him in the Democratic primaries because he was the only top-tier candidate to have opposed the Iraq war from the outset, now see worrying signs that their hero is a closet hawk. On the stump, he used to say things like: "I will bring this war to an end in 2009. So don't be confused." Now he says it might take a bit longer. To make matters worse, he has kept George Bush's defence secretary, Robert Gates, in his job. "Not a single member of Obama's foreign-policy [and] national-security team opposed the war," fumes Katrina vanden Heuvel, the editor of the *Nation*, a lefty magazine, adding that Mr Gates is "a terrible pick".

Far from ending Mr Bush's war on terror, Mr Obama plans to ramp it up in Afghanistan, albeit under a different label. When Israel started bombing Gaza, he barely protested. Medea Benjamin of Code Pink, an anti-war group, howled that Mr Obama "has been missing in action" while the people of Gaza were being massacred. Others go further. John Pilger, an Australian journalist, bristles that the vice-president, Joe Biden, is "a proud war-maker and Zionist", while Mr Obama's chief of staff, Rahm Emanuel, is a Zionist who "opposes meaningful justice for the Palestinians". Some folks are outraged, too, by Mr Obama's rumoured selection of Dennis Ross, a veteran of Bill Clinton's administration, as his point man on Iran. Robert Naiman, an analyst at a group called Just Foreign Policy, thinks Mr Ross might "set the stage for war with Iran". (Mr Ross favours offering Iran carrots and sticks to abandon its nuclear ambitions, but will not rule out military action.)

During the campaign, Mr Obama called the prison at Guantánamo Bay a “betrayal of American values” and promised to close it. On his first day in office he suspended legal proceedings against the inmates. But he has yet to figure out what to do with them. In an interview with the *Washington Post*, he said he would consider it a failure if he had not closed the prison system down by the end of his first term. On anti-terrorism policy generally, Dick Cheney, the former vice-president, recently remarked that before Mr Obama started to keep his campaign promises, he needed “to sit down and find out precisely what it is we did and how we did it.” Mr Obama described this as “pretty good advice”. The people who used to flock to his rallies with placards demanding that Mr Bush and Mr Cheney be tried as war criminals are aghast, not least because Mr Obama appears disinclined to prosecute anyone.

For the left, the list of Mr Obama’s betrayals—real or anticipated—is getting longer. His economic advisers are nearly all centrists. Far from bringing capitalism to heel, he is planning to save it. His choice for attorney-general, Eric Holder, used to work for big corporations, making him a “poster-child for… selling out,” grumbles David Corn of *Mother Jones*, a progressive magazine. Unions fret that Mr Obama will not campaign hard enough to increase their clout. Greens worry that he will not move fast enough to rescue the planet. The National Organisation for Women complains that his economic-stimulus package will pump too much money into male-dominated industries such as construction, leaving only scraps for teachers and social workers.

There’s no pleasing some people

Should Mr Obama worry about all this? Not much. For one thing, he is still hugely popular. A whopping 79% of Americans approve of him. Two days before the inauguration, when a preacher told a crowd that Mr Obama was not the Messiah, he was booed (in jest, one hopes). For another, Mr Obama is not breaking as many promises as his former fans imagine. Mostly, he is breaking only promises they think he made. Had they read the small print, they would have seen that he left himself some wiggle room. During his campaign Mr Obama was, as he put it himself, “a blank screen on which people of vastly different political stripes project[ed] their own views”. He gave a lot of people the strong impression that their most urgent goals were also his. As president, he can no longer maintain this illusion.

He must make trade-offs. He wants to cool the planet, but without stifling growth. He wants to close Guantánamo, but without freeing anyone who will then shoot up a shopping mall. He cannot govern from the centre without upsetting his left flank from time to time; nor should he try. He also wants to be re-elected and, if the past is any guide, he will pursue this goal with ruthless pragmatism. During the campaign, for example, he said he favoured civil unions but refused to endorse gay marriage. Cynical observers suspected a fudge—that he said this only to dull the sting of Republican attack ads. It seems the cynics were right: last week a gay paper dug up a long-lost questionnaire from 1996 in which he strongly endorsed gay marriage. In this case, Mr Obama really is more liberal than the image he projected. In others, the opposite may be true. The world will know soon enough.



Bolivia's new constitution

A passport to Utopia

Jan 22nd 2009 | LA PAZ
From The Economist print edition

Evo Morales campaigns for a great leap forward. Or back, say some

AP



IT HAS certainly been colourful. In peasant communities across the Andean highlands, Aymara Indian elders dressed up in ceremonial red ponchos and knitted caps, a rawhide whip knotted around one shoulder as a badge of authority, have been convening open-air meetings to urge support for a new constitution designed to give special rights and privileges to Bolivians of indigenous descent. Their wish is likely to be granted in a referendum on January 25th. But the new charter risks further dividing an already polarised country.

Its supporters, led by President Evo Morales, a socialist of Amerindian descent, argue that the constitution will reverse centuries of discrimination. An idealistic, almost Utopian document, it defines Bolivia, wordily, as “a United Social State of Plurinational Communitarian Law”. But opponents claim that, far from deepening democracy, its application will in practice undermine it.

Mr Morales is popular, in part because since taking office in January 2006 he has presided over a commodity boom (which is now fizzling). His support is particularly strong among the 50% of Bolivians officially classed as “indigenous”. Although the government has distributed the text widely, few Bolivians have read the new constitution—a 411-article blockbuster. Ministers have been loth to debate its details. They are trying to turn the constitutional vote into a referendum on Mr Morales and his attempt to “refound” Bolivia along “indigenous” and socialist lines. Since the president won a recall referendum on his rule last August with 67% of the vote, he seems likely to prevail, although the opposition has gained momentum in recent weeks.

Opponents claim that the new constitution will impose a dogmatic socialism, curtail human rights and undermine property rights and the rule of law. Opposition is led by regional leaders in the more prosperous eastern lowlands, but it also includes respected academics such as Carlos Mesa, a former president, and Víctor Hugo Cárdenas, an intellectual of Aymaran descent who as vice-president in the 1990s introduced bilingual education.

The new charter will give sweeping rights to the country’s 36 indigenous groups (some of whom number only a few hundred people). Supporters argue that this reverses centuries of injustice since the Spanish conquest, and ensures that a “white” minority can no longer boss Indians around. Critics say the constitutional blessing of collective rights and traditional authorities smacks of corporatism and will entrench undemocratic *caciques* (political bosses).

The text gives official recognition to “community justice” imparted by elders, and introduces the popular election of judges and members of a judicial council. These measures are intended to clean up a corrupt judiciary. Opponents say they will politicise justice, create jurisdictional conflicts and uncertainty for the police, and legitimise mob justice in the form of lynchings and stonings, which have become more common over the past two years.

In a supplementary question Bolivians will also be asked to choose to limit landholdings either to 5,000 hectares (12,400 acres) or to 10,000 hectares. This is to curb the power of big landowners in the east, some of whom gained their land illegally from military governments. Many of them are among Bolivia’s most efficient farmers.

The constitution mandates “social control” of public institutions by “organised civil society”. This provision, too, is ostensibly aimed at cutting corruption. How it would work in practice is unclear, but critics fear that it will legitimise mob rule. Education is to become “decolonising”, “liberating” and “revolutionary”—or doctrinaire and partisan, if you prefer. The Catholic church has been angered by clauses which could be interpreted as legalising abortion and gay marriage.

The opposition worries that in the highlands the vote may not be free. It notes that in some peasant communities Mr Morales won almost 100% of the votes in the recall referendum. That may reflect an Amerindian tradition of collective decision-making. “We are not telling our people what to vote, they are aware of what is going on, they already know what to vote,” says Oscar Mamani, an elder in Collana, a village south of La Paz. In the capital, government supporters are less coy. Government workers and money have been shamelessly mobilised to campaign for a yes vote.

If they triumph, a new general election will be held in December, in which Mr Morales would be able to run for a second term. Some leaders of his Movement to Socialism want to bring the election forward. Bolivia’s economic outlook is dark. Mr Morales scared off investment by nationalising the natural-gas industry, telecoms and parts of mining. That boosted government revenues in the short term, but is now jeopardising them. Miners are being laid off because of plunging mineral prices. The price of gas exports has fallen too, while Brazil (the main market) has cut imports by a third because of a slowing economy and plentiful rainfall for hydroelectricity. To make matters worse, Bolivian migrants are returning from recession-hit Spain, cutting remittances. The public finances are set to go into deficit this year.

At heart, the constitutional referendum involves a choice as to whether or not Bolivia should graft on to an imperfect Western liberal democracy a socialist model that owes rather more to the corporatism of Spanish colonial rule (but with Amerindians, rather than conquistadors, in charge) than to Marx. A less confrontational president than Mr Morales might find a more harmonious way to blend the two. As it is, his probable victory risks setting his country on a path of chaotic conflict, government paralysis and continuing economic backwardness.

Economic policy in Mexico

Damage control

Jan 22nd 2009 | MEXICO CITY
From The Economist print edition

A Latin American country softens recession with counter-cyclical policies

MANUFACTURERS and banks are firing workers. The value of wages fell last year. Credit card debts are piling up. The economy began to contract in the last quarter of last year. Mexico has been here before. But there are two big differences between this recession and the three that preceded it in the past quarter of a century. This time the problem stems from economic mismanagement in the United States, not at home. And for the first time Mexico's government is in a position to lean against the economic cycle with expansionary fiscal and monetary policies.

On January 16th the Bank of Mexico, the independent central bank, cut its benchmark interest rate by half a percentage point (to 7.75%). It was the first cut since April 2006, but will not be the last. Having worried about inflation, which climbed to 6.5% last year, the bank is now more concerned about the sinking economy.

Days earlier President Felipe Calderón unveiled fiscal measures amounting to an injection of 1% of GDP, including cuts in energy prices, extra investment in roads, railways and oil wells, and measures to extend medical cover, welfare benefits or temporary jobs to the unemployed. That comes on top of an expansionary budget for this year, and a previous fiscal stimulus last October (which included extra payments to poorer Mexicans). All told, the government is injecting about three percentage points of GDP.

Officials are under no illusion that this will prevent recession. Few countries are as vulnerable as Mexico to the turmoil originating in the United States. The North American Free-Trade Agreement has tied industry in both countries closely together (see chart). Remittances from Mexicans working across the border fell sharply in November, while fewer tourists will venture south. The finance ministry talks of zero growth for 2009, but that is "optimistic", says Guillermo Ortiz, the Bank of Mexico's governor. It assumes a recovery in the United States (and Mexico) in the second half of the year.



Officials hope, however, they can at least limit the damage from the global credit crunch. This hit Mexico suddenly in September, when the peso devalued (it has lost about 25% of its value against the dollar). Several Mexican companies lost billions on derivative contracts (one of them, Comercial Mexicana, a large retailer, went bankrupt). The foreign banks that dominate Mexico's financial system stopped lending, as they shored up their balance-sheets at home.

The government stepped in, guaranteeing credit lines and offering loans to small businesses through the development bank, Nafinsa. The peso has stabilised after the central bank spent $15 billion of its reserves; it still has $85 billion, plus a swap line of $30 billion from the United States Federal Reserve which it has not used. The volume of bad debts is rising, especially on credit cards. But the financial system is solid, and credit is available again—at a price. The risk premium (over the yield on United States treasury bonds) on Mexican corporate bonds has risen fivefold to over 1,000 basis points, says Mr Ortiz.

The government's efforts are aimed at limiting the social impact of recession. The fiscal measures might save up to 150,000 jobs, says one official. Even so, with about 900,000 joining the workforce each year, unemployment is bound to rise (it climbed from 4% to 4.8% in November alone). Migration to a recession-hit United States no longer offers much of a safety valve.

In past recessions Mexico has had to cut public spending. That it is different this time is tribute to the health of public finances. Public debt is only around 30% of GDP (and a fifth of that comprises contingent liabilities that the government may never have to repay). Only $3.2 billion of foreign public debt falls due this year—and the government has already raised $2 billion in a bond issue last month. Skilful hedging by the finance ministry has softened the fall in the price and production of oil, which provides a third of government revenue. Mexico presold its oil output for 2009 at $70 a barrel—almost twice the current market price.

If recession persists into 2010, the government can still stimulate the economy, albeit on a smaller scale, points out Alejandro Werner, the deputy minister of finance. When the economy was growing, the government saved a sum equivalent to 1.8% of GDP in stabilisation funds which have not yet been spent. And the devaluation of the peso means that dollar oil revenues will go further in pesos.

This greater resilience applies, too, to Mexico’s manufacturing industry. Many firms went bankrupt or moved in the last recession in 2001, when they were unable to compete with China after it joined the World Trade Organisation. Those that remain are much more efficient and have cut costs “furiously” since the middle of 2007, according to Alfredo Thorne of JPMorgan, an investment bank. They will be helped by devaluation. This might normally prompt more American firms to move south of the border. They are being discouraged by a wave of violent crime.

The recession is a blow to Mr Calderón’s hopes of winning a majority in a legislative election in July. It is a small consolation that the government can act to curb the damage. It would be a bigger one if it felt emboldened to undertake the structural reforms—of monopolies in energy, telecoms and television, for example—that Mexico needs to become a more dynamic and competitive economy.

Fugitives from justice in Brazil

The madness of asylum

Jan 22nd 2009 | SÃO PAULO
From The Economist print edition

Why this indulgence for a convicted killer?

AP



Italians don't see Battisti's joke

WITH its extensive opportunities for committing fresh indiscretions and its giant statue of Christ extending limitless redemption, Rio de Janeiro is an attractive place in which to live as a fugitive from justice. Claude Rains elegantly hid out there in one of Alfred Hitchcock's best films. Ronald Biggs, having robbed a mail train in 1963, swapped a British prison for Copacabana beach—and was more envied than vilified as a result. Now Cesare Battisti, an Italian thriller-writer who was once a member of a group called Armed Proletarians for Communism, has joined the list after Brazil granted him refugee status.

Before he came to Rio, Mr Battisti enjoyed a comfortable exile in France. Italy and France have long argued, in the way only neighbours can, about the number of once-violent Italian activists who have settled in Paris. Last year the French government refused to extradite Marina Petrella, a former Red Brigades terrorist (Carla Bruni, the president's wife, went to Mrs Petrella's hospital bed to give her the good news). Italy's government had hoped Brazil would be more helpful. But its protests have been met with a snort from President Luiz Inácio Lula da Silva, of the sort reserved for occasions when he thinks a more developed country is telling Brazil what to do.

Mr Battisti was convicted in absentia of killing two policemen in Italy in the late 1970s. He was also found guilty of taking part in the murder of a butcher, and of helping to plan that of a jeweller (shot in front of his 14-year-old son). Mr Battisti denies these charges, but there is little doubt in Italy that his trial was fair.

Brazil's reasons for protecting Mr Battisti are unconvincing. The justice minister, Tarso Genro, referred to his country's tradition of harbouring political exiles, ranging from Alfredo Stroessner, a particularly nasty ex-dictator (of Paraguay), to Olivério Medina, an ex-guerrilla (in Colombia). Now that democracy is the norm in the Americas, that tradition is anachronistic. Mr Genro also seems to think that Mr Battisti was convicted of political crimes, rather than plain murder.

Two sentiments underlie Mr Genro's reticence. One is Brazil's reluctance to examine its own past. Whenever the question of an inquiry into the military government of 1964-85 arises, it is quickly squashed (unlike similar demands in Argentina or Chile). The second sentiment, that of solidarity, is to be found among some members of Lula's party who were far-left militants in the 1970s. In Italy, which lost a former prime minister to the Red Brigades and had a government adviser murdered as recently as 2002 by its imitators, attitudes are much less indulgent.

Religion in Canada

Wives galore

Jan 22nd 2009 | VANCOUVER
From The Economist print edition

Just part of being free?

AFTER decades of tolerating what has come to be seen as a dirty little secret, British Columbia's government is at last taking action to end the practice of polygamy by a Mormon sect. This week two leaders of a commune called Bountiful appeared in court to answer criminal charges. But the case may expose a conflict between constitutional guarantees of freedom of religion on the one hand and the criminal law on the other.

Bountiful was set up in 1946 after half-a-dozen men were excommunicated from the mainstream Mormon church, which banned polygamy in 1890. They moved north to practise it in British Columbia's Creston Valley. The commune, whose thousand or so residents are almost all progeny of the male founders, follows the precepts of the breakaway Fundamentalist Church of Latter-Day Saints based in Utah. This sect teaches that to enter heaven, men must have three or more wives and as many children as possible. Women are taught that their role is to serve men.

The patriarchal leader directs who is to marry whom and when. Some women who have fled have described how teenage girls (as young as 15) have been married off to polygamous men three times their age, and are then having babies (the teenage birth rate of Creston is three times the provincial average). They also say that under-age girls are swapped with similar communes south of the border for arranged marriages and as "breeding stock".

AP



Blackmore and a small sample of his daughters

The sect has never hidden its beliefs. One of the two men charged, Winston Blackmore, the former "bishop" of the community, who has had 26 wives and 108 children, spoke candidly about polygamy in a television interview in 2006.

The police first investigated Bountiful in 1991. But the province's attorney-general decided against charges, arguing that Canada's Charter of Rights and Freedoms, which guarantees freedom of worship, would trump the criminal code. The current occupant of the job, Wally Oppal, disagrees. But the outcome of the case is uncertain. If found guilty, the defendants may appeal all the way to the Supreme Court.

The charter, approved in 1982, has expanded civil rights. But some lawyers and victims' groups complain it has encouraged courts to throw out well-founded cases because of technical flaws in police procedure. "It has become a charter of rights for criminals," says Wallace Craig, a retired British Columbia judge. It is the (often unjust) fate of human-rights legislation to attract such populist criticism. But if the charter allows the leaders of Bountiful to flout the law, many may believe that the critics have a point.

China's flagging economy

Strong as an ox?

Jan 22nd 2009 | HONG KONG
From The Economist print edition

The Chinese economy is stumbling. How much worse can it get?

Illustration by Claudio Munoz



THE beast which gives its name to the Chinese new year that begins on January 26th is meant to symbolise prosperity through fortitude and hard work, offering hope that China will soon regain its economic vigour. But an ox is often a castrated bull—which may be an apt description of China's economic pain. New figures show that China's GDP growth fell to 6.8% in the year to the fourth quarter, down from 9% in the third quarter and half its 13% pace in 2007. Growth of 6.8% may still sound pretty robust, but it implies that growth was virtually zero on a seasonally adjusted basis in the fourth quarter.

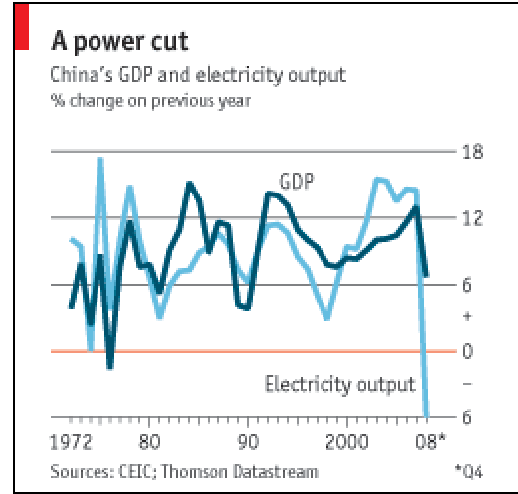
Industrial production has slowed even more sharply, growing by only 5.7% in the 12 months to December, compared with an 18% pace in late 2007. Thousands of factories have closed and millions of migrant workers have already lost their jobs. But there could be worse to come. Chinese exports are likely to drop further in coming months as world demand shrinks. Qu Hongbin, an economist at HSBC, forecasts that exports in the first quarter could be 19% lower than a year ago. 2009 may well see the first full-year decline in exports in more than a quarter of a century.

Economists have become gloomier about China's prospects, with many now predicting GDP growth of only 5-6% in 2009, the lowest for almost two decades. The most dismal view comes from Albert Edwards, at Société Générale, a French bank, who thinks China may be sliding into outright recession. He points to a fall in electricity output of 6% in the year to the fourth quarter, down from average annual growth of 15% over the previous five years.

In the past, the growth in GDP and electricity use have tended to move together (see chart). Mr Edwards reckons that a decline in electricity output may mean that GDP is falling, no matter what the official figures say. Equally worrying is the OECD's leading indicator of economic activity in China, which has plunged to its lowest level in its 26-year history, lower even than during the slump in 1989, the year of the Tiananmen Square protests and massacre.

This makes for a compelling story. But the relationship between GDP and electricity consumption has been distorted by the uneven nature of this slowdown. Energy-guzzling heavy industries, such as steel and cement, bore the brunt of China's downturn late last year. So it is not surprising that electricity use slumped.

Moreover, too much weight may be given to the declining exports, because it is often wrongly assumed that the slump in China's growth has been caused mainly by a collapse in its exports to America and other rich economies. Yet in 2008 the fall in net exports (exports minus imports) accounted for less than half of its slowdown. More important was a collapse in housing construction, caused by the government's efforts to deflate a potential bubble. This, in turn, reduced the demand for materials such as steel. So by the fourth quarter there had been a huge build-up in stocks, exacerbating the fall in production: steel output was 12% lower than a year earlier.



GDP growth is likely to continue to fall during the first half of 2009, sounding alarm bells among those who repeat the official mantra that China needs to grow by at least 8% a year to avoid social unrest (even though that number has no sound economic basis). But there is good reason to hope that by midyear the economy will perk up as destocking comes to an end and the government's fiscal stimulus kicks in.

China's 4 trillion yuan ($585 billion) package of infrastructure spending, subsidies and tax cuts for businesses has been trashed by many commentators as another "Chinese fake". Most of it is not new money, they claim, and the central government will finance less than one-third of the planned spending; most of the rest will have to come from banks, which in the current climate may be reluctant to lend.

It is true that some of the extra spending had already been announced, but what matters for economic growth is how much spending will actually increase this year. The answer is a lot. For example, JPMorgan forecasts that transport investment will expand by an impressive 70% in 2009. HSBC estimates a total spending boost of 6-7% of GDP over this year and next.

Since the November package, the government has introduced other measures to support the economy. On January 21st it announced extra spending of 850 billion yuan over three years to improve health care. From February rural residents will get a 13% rebate on purchases of goods such as refrigerators, TVs and washing machines. Consumer spending will be dented by job losses and smaller wage rises but has so far remained strong, with retail sales up by 18% in real terms in the year to December. Interest rates have also been cut five times since September and, much more important, controls on bank lending have been scrapped. To help the property sector, minimum down-payments have been reduced from 30-40% of a home's value to 20%, the transaction tax has been waived for properties held for at least two years, and more public housing is to be built.

The all-too visible hoof

Chris Wood, at CLSA, a brokerage, says the effectiveness of the stimulus hinges on the extent to which China is now a capitalist economy. The more "capitalist" it is, the deeper the downturn now; the more it is still a command economy, the better the chance of recovery in 2009. State-controlled firms, which account for one-third of industrial output and almost half of all investment, have been "asked" not to cut jobs and capital spending. All the big banks are state-owned and their chairmen are appointed by the government. If they get a phone call telling them to lend more, they are likely to do so.

Banks already seem to be following Beijing's orders: total lending surged by 19% in the year to December. China is one of the few large economies whose banking system has not been crippled by the global credit crunch. Andy Rothman, also at CLSA, argues that "in China, there is only a credit crunch when the political leadership wants one". He believes the economy will revive by midyear and achieve GDP growth of close to 8% for 2009 as a whole.

The obvious concern is that although heavy-handed government meddling may be more effective than market-based tools to pull an economy out of a deep downturn, it comes at a cost. Public investment will inevitably include some wasteful spending, and politically directed lending could add to excess capacity in some sectors and create new bad loans for banks. This may hobble the bull in the future. But first it needs to regain its virility.

A defence white paper in China

White lies

Jan 22nd 2009 | BEIJING
From The Economist print edition

A 105-page paper sheds little light on China's expanding military might

CHINA'S armed forces are enjoying an unusual year in the sun. Destroyers are cruising pirate-infested waters off Somalia in the modern navy's first active mission beyond the Pacific. Preparations are under way for the first full-scale military parade in Beijing in a decade. But the habits of the shade lie deep: a defence-policy paper published by the government on January 20th suggests little change in a disquieting preference for opacity.

The deployment in the Gulf of Aden, from this month, is rare for the navy, which has hitherto kept much closer to shore. It has not been to east Africa since the celebrated mariner Zheng He reached Somalia with a massive fleet in the 15th century (on a friendly visit, says China). The Chinese vessels—two destroyers and a supply ship along with special-forces troops—are escorting commercial vessels through the gulf. Several Chinese ships have been among those attacked by pirates off Somalia in recent months.

The Chinese navy's presence has been welcomed by America, one of several countries involved in anti-piracy operations in the gulf. Admiral Timothy Keating of the United States Pacific Command said it could encourage renewed dialogue between the American and Chinese armies. Contacts were disrupted last October by news of America's proposed sale of arms to Taiwan worth $6.5 billion. But the Americans and many others, notably China's neighbours, remain anxious about China's longer-term military ambitions.

China's new defence "white paper" is aimed at dispelling such concerns. It is the sixth in a series of such documents published since 1998. None has impressed the Americans, who worry about China's rapid acquisition of sophisticated weaponry, including the Chinese-made destroyers off Somalia and an array of Russian hardware. The Pentagon's annual report on China's army last year criticised its "lack of transparency" for increasing the potential for "misunderstanding and miscalculation".

The Chinese document snipes back at the Americans, saying their arms sales to Taiwan have been causing serious harm to bilateral relations and to peace and stability in the Taiwan Strait. As usual it gives few details of China's own weapons. Last month a Chinese spokesman said the country was seriously considering whether to build its first aircraft-carrier. But the white paper is silent on the topic, long a subject of speculation abroad. An aircraft-carrier would enable China to project power much further afield.

China's arsenal will be put on dramatic display at a parade through Beijing on October 1st, the 60th anniversary of the founding of the People's Republic. This will be only the third such show since the beginning of China's "reform and opening" in the late 1970s. China's state-run news agency, Xinhua, quoted a general as saying—without apparent irony—that the parade would display the military's "transparent image". Previous parades have involved everything from intercontinental missiles and tanks to fighter jets flown overhead. This year Zhang Yimou, a film director who choreographed the opening ceremony of the Beijing Olympics, is to arrange a gala afterwards.

A senior officer, apparently mindful of possible resentment of such extravagance at a time of economic hardship, has said the parade will be "frugal" although it would still involve "more new weapons". A newspaper in Beijing has quoted the Hong Kong press (sometimes a way of showing official approval of unofficial information) as reporting that, as a gesture to Taiwan, there might be fewer short- and medium-range missiles on display than there were at the 1999 parade.

The white paper says nothing of the deployment of hundreds of missiles along the Chinese coast facing Taiwan in the past few years. But it does convey how much China's view of Taiwan has changed since Ma Ying-jeou became president last May. Separatists in Taiwan have been "thwarted", it says, and relations have taken a "significantly positive turn". For America, too, this at least is welcome news.

Political corruption in Taiwan

Trial and error

Jan 22nd 2009 | TAIPEI
From The Economist print edition

A former president and the judiciary are both in the dock


AFP

CHEN SHUI-BIAN, Taiwan's president from 2000 to 2008, this week pleaded not guilty at a hearing marking the start of his trial on corruption charges. Mr Chen, who ruled on a confrontational platform of independence from China, looked tired and dispirited, but was as combative as ever. "There is no way I can accept these charges and insults," he told judges, after arriving at a Taipei court in handcuffs. His supporters are trying to ensure it is not just Mr Chen's probity but also the integrity of Taiwanese justice that are on trial.

In one case he is alleged to have influenced the government to buy land from a company that bribed his wife, Wu Shu-chen. The couple is also charged with embezzlement from special presidential accounts, with forgery and with laundering ill-gotten money through Switzerland.

Mr Chen, who might face a life sentence, insists he is innocent and faces what amounts to political persecution. This week prosecutors produced two new charges, of extortion and profiteering in connection with the land deal. Mr Chen accused them of making Taiwan's president seem like a local bully or mafia boss: "I don't know whether to laugh or cry."

Mr Chen is very unpopular. And his case was dealt a blow later in the week when his son, daughter-in-law and brother-in-law all pleaded guilty to laundering large sums of money for the family.

Nevertheless, Mr Chen's trial is a test for Taiwan's two-decade-old democracy, which has already managed two peaceful transfers of power to the opposition. Many are heartened that corruption, long endemic in politics, is being attacked and that a former president can stand trial like a common citizen.

Critics, however, say recent judicial proceedings have been marred by sloppy improprieties, and, some allege, bias towards the Nationalist party, the Kuomintang or KMT, which took power last May under President Ma Ying-jeou. Mr Chen was imprisoned incommunicado for a month before he was charged, raising questions about the presumption of innocence. A panel of judges that released Mr Chen from prison without bail last month was mysteriously replaced by a new one that ordered his reimprisonment a fortnight later. Prosecutors had appealed and KMT politicians had complained, leading to suspicions of political interference. The same judges are presiding over his trial.

Bruce Jacobs, a Taiwan expert at Monash University in Australia, points out that recent corruption investigations have mainly been aimed at opposition politicians; prosecutors seem far less interested in investigating KMT figures. He also points to the "lack of discretion" in a remarkably tasteless recent incident: prosecutors involved in Mr Chen's case performed a comic skit at a party at the justice ministry. To the glee of the audience, one is said to have mimicked the former president's arrest by raising handcuffed hands above her head and shouting slogans. Shown on television, this outraged many.

Mr Ma's spokesman denies any party-political bias among prosecutors, and insists the president respects judicial neutrality. But even it that is true, the judiciary's lack of professionalism risks creating public cynicism about its independence, undermining both the drive against corruption and respect for the courts' decisions.



WORLD
ASIA

South Korea's troubled government

Up in flames

Jan 22nd 2009 | SEOUL
From The Economist print edition

A cabinet shuffle overshadowed by tragedy

BY SHUFFLING his cabinet this week, South Korea's president, Lee Myung-bak, had hoped to give his beleaguered administration a fresh start. That hope was dashed within two days. Kim Seok-ki, the chief of Seoul's police force and the president's nominee to head the national police agency, faced questions in parliament, and calls for his appointment to be rescinded, after a police raid on illegal squatters in Seoul led to the deaths of six people in a fire. Mr Kim, who last year used aggressive tactics to control demonstrations against imports of American beef, ordered the raid.

The president sent his prime minister, Han Seung-soo, to face a press conference, where he bowed in remorse for the deaths. The incident distracted from Mr Lee's efforts to tackle the country's two thorniest problems: the economy, which this week was revealed to have shrunk by 5.6% in the fourth quarter of 2008, and North Korea. Mr Lee this week announced new ministers for finance and unification (ie, dealing with the North). Parliament, where his party has a majority, is likely to endorse his choices.

The replacement for Kang Man-soo, the hapless finance minister, is Yoon Jeung-hyun. Mr Yoon comes with a mixed record. During the Asian financial crisis a decade ago, he was a senior bureaucrat in the finance ministry. He was one of those blamed for the rapid deterioration in South Korea's finances, which eventually demanded a massive IMF bail-out. He went on to run the regulator, the Financial Services Commission, as it presided over credit-card and property bubbles. Now he will have to co-ordinate the government's floundering efforts to stem declines in the currency, stockmarket and foreign-exchange reserves. He will also have to rally the National Assembly behind the president's plans to sell state assets and invest more in infrastructure and clean-energy projects. Mr Lee's Grand National Party remains factionalised, and has failed to unite behind his economic plans.

The new unification minister, Hyun In-taek, a professor of politics, was the architect of Mr Lee's North Korea policy, which offered the hungry, bankrupt nation aid and investment on condition it gave up its nuclear weapons. But the North saw this as an infringement of its sovereignty. For months it has refused to talk to the South. This month it has threatened "all-out confrontation", blaming Mr Lee for raising tensions. Baek Seung-joo, of the Korea Institute for Defense Analyses, a Seoul think-tank, believes the North's present bellicosity may reflect political instability following the illness said to have afflicted its dictator, Kim Jong Il. Analysts think North Korea's priority is its relationship with the new American administration. Relations with the South are in the deep freeze, and unlikely to thaw until this winter is long gone.



WORLD
ASIA

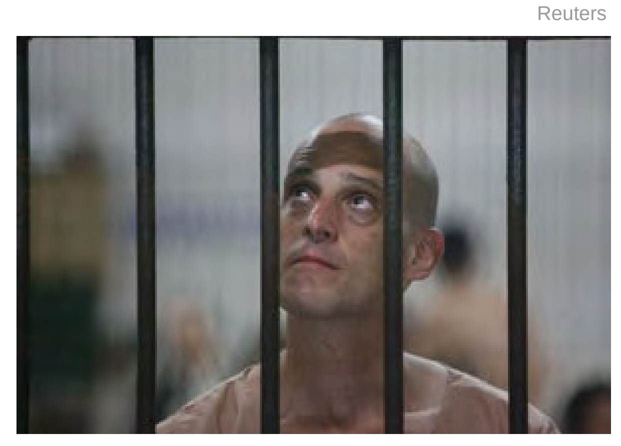
Thailand's lèse-majesté law

The trouble with Harry

Jan 22nd 2009
From The Economist print edition

A little-read novelist and inadvertent Roundhead ends up in jail

Reuters



The author in prison: worse than a bad review

"IS THE truth, the truth?" asks the cover of "Verisimilitude", a novel by Harry Nicolaides. On January 19th a Thai criminal court ruled that it was a little too close for comfort. Citing a paragraph in the book on the lurid private life of an unnamed crown prince, the court convicted its author of dishonouring Thailand's royal family. By the standards of the country's *lèse-majesté* laws, Mr Nicolaides, an Australian, got off lightly. He was sentenced to three years in jail, reduced from six years, after he pleaded guilty. He is now seeking a royal pardon and deportation to Australia.

He will not be the last in the dock. Police already have a bundle of *lèse-majesté* cases on the go. A left-wing academic, Giles Ungpakorn, was charged this week for defaming the monarchy in a book on the coup in 2006 that deposed Thaksin Shinawatra, then prime minister. Thailand's new government says defending the crown is a priority. Pirapan Salirathavibhaga, the justice minister, is creating a 24-hour "war-room" to monitor online threats. Thousands of websites have been blocked for alleged *lèse-majesté*, though anti-censorship groups say the net is cast wide to stifle political debate. Some Thai bloggers have been detained after posting rebellious comments.

The political background to this frenzy is hard to miss. During last year's protracted street rallies, a rowdy mob known as the People's Alliance for Democracy (PAD) pinned its royalist colours firmly to the mast. It was rewarded, at a critical juncture, by the appearance by Queen Sirikit, wife of King Bhumibol, at the funeral of one of its supporters. The subsequent change of government appeared to seal a royalist victory for the PAD and its blue-blooded backers.

A backlash may be brewing, though, and not just among Bangkok's chattering classes. Conventional wisdom holds that public reverence of Bhumibol, 81, is genuine and deeply felt. The same patently does not apply to the heir apparent, Crown Prince Vajiralongkorn. Palace propagandists have struggled to burnish his image. Indeed, private gossip on the foibles of royals has never been sharper. Some intellectuals are pushing at the margins for freer speech. A petition signed by 128 academics from several countries calls for charges against Mr Ungpakorn to be dropped. But the biggest shift (though the hardest to measure) appears to be under way among ordinary Thais who are tiring of the royal charade. Repressive laws may not be enough to stop a tidal wave of straight talk.

Amid this soul-searching, Mr Nicolaides makes for an unlikely martyr. His self-published 2005 novel, a turgid English-language romance spiced with commentary on Thailand, sold fewer than ten copies. Its author, a former lecturer at a Thai university, says that it was later withdrawn from circulation in Thailand, on the orders of the Ministry of Justice. Case closed, or so he believed—until he was detained last August at Bangkok airport on a *lèse-majesté* charge. He says he meant no offence to the monarchy and was

unaware of the law. He described his trial as an “Alice in Wonderland” experience.

Thais who run foul of the law can expect worse. A female activist was sentenced in November to six years in jail for a speech at a rally in Bangkok. A fellow speaker whose fiery digs at the crown were cheered by onlookers is awaiting trial. Both have been denied bail, as was Mr Nicolaides. If this were Myanmar, governments like Australia’s would line up to denounce the arbitrary use of archaic laws and defend the rights of dissidents. Instead, it is meekly waiting for a royal pardon so it can spirit its citizen back home.



Thailand's Burmese boat people

Cast adrift

Jan 22nd 2009 | BANGKOK
From The Economist print edition

Myanmar’s unwanted human flotsam

OF ALL the myriad groups fleeing the misery of modern Myanmar, few have suffered more than the Rohingyas, a shunned Muslim minority, concentrated in Rakhine state. Denied full citizenship at home, many end up in Bangladesh, where some 200,000 live in squalid border camps. Another 28,000 are housed by the United Nations High Commissioner for Refugees (UNHCR). The lure of further migration is strong. Every winter thousands pay to board rickety smugglers’ boats for Thailand, whence a bus can take them to Malaysia, to seek work or asylum.

This season Thailand’s soldiers had a nasty surprise in store. After being held for days on a remote island off Ranong, two groups of nearly 1,000 captured Rohingyas and Bangladeshis were forced, at gunpoint, out to sea in the Indian Ocean on several boats. The vessels had little food and, crucially, no engines. Some drifted west to India’s Andaman islands. Others washed up in Indonesia’s Aceh province. Over 500 are believed missing or dead, according to a tally of survivors’ accounts. One group of over 400 refugees was set adrift on a barge with two sacks of rice and two gallons of water. Most perished trying to swim ashore. On January 7th the Indonesian navy rescued another group of 192. Others may have been lost at sea.

For Thailand, the survivors’ accounts, provided to far-flung authorities in India and Indonesia, as well as to human-rights groups and reporters, are damning, to say the least. Sending refugees back to danger is bad enough. Casting them adrift to die is much worse. In the past, Rohingya refugees caught in Thailand were handed over to the immigration authorities, says Chris Lewa, a longtime advocate for Rohingya rights. Many were later quietly sold to traffickers, either to work as slave labour in Thailand or, preferably, to continue their journey to Malaysia.

Nearly 5,000 have been detained in Thailand in the past two years. Many more probably went undetected. But the military mindset has changed: undocumented Muslim men travelling through southern Thailand, where a Muslim-led separatist insurgency has raged for five years, are now a no-no. Army officials claim, without any evidence, that Rohingyas are joining the insurgency. This is cited as justification for a harsh expulsion policy, as a deterrent. UNHCR officials have tried to alert restless refugees in Bangladesh of the dangers. The agency is also pressing the Thai authorities to grant it access to 126 Rohingya boat people believed to be still in detention.

The prime minister, Abhisit Vejjajiva, has said reports of abandonment at sea are “exaggerated”, but has promised a full investigation. The army has issued blanket denials of any ill treatment without fully explaining what actually happened to the shipwrecked Rohingyas. The abuses date from before Mr Abhisit took office last month. But they put him in a tough spot. He has also promised to tackle abuses by the army in combating the southern insurgency, including the alleged torture and murder of Muslim suspects in custody. Last month a court in the region ruled that soldiers had tortured and beaten to death a Muslim preacher. Justice is sorely lacking in the south. Mr Abhisit, to his credit, has promised to put that right. But going toe-to-toe with the army brass, who helped him into office, will test his political courage.

India and Pakistan

Diplomatic outsourcing

Jan 22nd 2009 | DELHI
From The Economist print edition

India's disillusionment with its allies

AP



BrahMos: the alternative to jaw-jaw?

ON JANUARY 26th India will celebrate Republic Day, a national holiday to mark the adoption of the constitution. Troops will march past the ramparts of Delhi's Red Fort, camel-mounted cavalry will charm onlookers, and the air force will fly overhead. But six days before the big occasion, India held a more pointed show of force. In the desert near Pakistan, it tested a BrahMos cruise missile, with a range of 290km (180 miles). The trial was routine. But in these tense times, the missile bore a full payload of symbolism.

India's government is dissatisfied with Pakistan's grudging response to the attacks on Mumbai last November. It suspects the terrorists acted with the army's tacit consent and perhaps its active connivance. It wants Pakistan to shut down the infrastructure of terrorism—the networks that recruit, train, equip and finance jihadists—and to hand over a list of suspects, accused of plotting terrorist atrocities in India.

To bolster its demands, India is counting on outside powers to intercede on its behalf. Measured in air-miles, the diplomatic effort has been impressive: Joe Biden, America's new vice-president, and Condoleezza Rice, its former secretary of state, have made the trip to Islamabad, as have Britain's prime minister, foreign secretary and defence secretary.

But the results of this globe-trotting are harder to verify. Pakistan eventually admitted that India had "provided significant proof" of the involvement of Pakistan nationals, but it insists they acted without state support. It has outlawed Jamaat-ud-Dawa, which was a front for the terrorist group that nurtured the Mumbai attackers. It has closed some camps and arrested scores of people. But Pakistan has never handed over one of its nationals to India for trial. It is not ready to start now.

Pakistan says it will act on the evidence India has given and prosecute the guilty itself. If it held a free, fair trial, open to all countries that lost citizens in the carnage, "I think India would live with it," says Commodore Uday Bhaskar, of the Institute for Defence Studies and Analyses in Delhi.

It might have to. Britain, for one, is not prepared to push the point. According to a spokesman for Britain's foreign office, the government is not opposed to extradition, but "neither do we see it as a necessary condition for justice to be done".

America, for its part, needs Pakistan's help in Afghanistan, where the superpower is still struggling with a resurgent Taliban. About three-quarters of the food, fuel and other provisions that supply American troops pass through Pakistan. General David Petraeus, head of America's Central Command, says that Russia and its Central Asian neighbours will provide other routes. But these will not be instantly available or free of political cost. Russia, in particular, may "demand that the United States acknowledge a Russian sphere of

influence in the former Soviet Union," says Stratfor, a consultancy based in Texas.

Aspiring great powers never "outsource security", laments Bharat Karnad of Delhi's Centre for Policy Research in *Mint*, an Indian newspaper. He thinks India squandered the chance for a swift military reprisal. If it is hit by terrorism again, it may yet unsheathe some of the weaponry it will display on Republic Day. But a military strike carries non-military risks. It will rally Pakistan behind its army, bolster the country's extremists and undermine its democratic government. On January 21st Indian army boffins admitted that the latest BrahMos test had suffered a hitch: the missile missed its intended target. An attack on Pakistan could easily do the same.

Diplomacy after the Gaza war

Now get back to making peace

Jan 22nd 2009 | CAIRO
From The Economist print edition

But the battle has deepened the bitter divisions between the Arabs, as well as between the Palestinians and Israel

Illustration by Peter Schrank



THE wreckage of the war in Gaza is bad enough. According to Palestinian estimates, one in seven of the crowded territory's buildings has been completely or partially destroyed, leaving tens of thousands homeless amid losses valued at nearly $2 billion. In three weeks of bombing, some 1,300 of Gaza's 1.5m people may have been killed and many thousands wounded—almost as many as the number of Britons, proportionally, who were killed by the German blitz in the second world war. Yet the political repercussions of this war may reach further than the physical damage.

The peacemakers barely know where to start. The old divisions, not just between Israelis and Arabs but also between rival Palestinian factions and their bickering foreign backers, have got deeper. Political rows are already muddling the urgent task of getting aid to Gaza, let alone efforts to secure the fragile ceasefire, rebuild the territory and forge a broader Arab-Israeli peace.

King Abdullah of Saudi Arabia, speaking at a recent, fractious Arab summit meeting in Kuwait, gave warning to Palestinians that their own rifts were "more dangerous than Israeli aggression". Palestinians who have long despaired at the quarrel between Fatah, the secular, peace-talking party that runs the West Bank, and Hamas, the Islamist champion of "resistance" which won legislative elections in 2006 and seized power in Gaza a year later, would heartily agree. Yet although the war has prompted a chorus of demands for the parties to come to terms before the Gaza-West Bank split dooms any chance of a unified Palestinian state, it has also accentuated their differences.

Hamas spokesmen accuse Mahmoud Abbas, the Fatah leader and internationally recognised head of the rump government known as the Palestinian Authority (PA), of colluding with Israel's onslaught. Hamas says that since his term as president has expired he should step down. Some mutter that Fatah agents even gave intelligence to enable Israel to assassinate several top Hamas officials. According to some reports, Hamas has already killed suspected Fatah "collaborators" in Gaza.

The war's longer-term impact on Palestinian opinion is hard to assess. Opinion polls before the fighting had shown a steady erosion of support for the Islamists, even in Gaza, where the PA still pays state salaries. A wartime surge in emotional identification with Hamas is likely to fade, but this may not boost Mr Abbas, whose efforts to coax Israel into peace, while lauded in the West, have produced few gains on the ground. The Fatah leader provoked outrage when he blamed Hamas for stupidly provoking Israel's attack, then told police to stamp out protests in the West Bank, which Fatah still controls. "He is now a political corpse," says one independent Palestinian analyst, suggesting that younger Fatah activists, who have long bridled at the group's domination by an aid-padded coterie of Mr Abbas's loyalists, may now try not only to oust them but to renounce peace talks with Israel.

The weakening of the Fatah-run PA has prompted some in both parties to call yet again for a unity government and for early elections to give a new government a more legitimate mandate. But while harder-line members of Hamas say the heroism of their self-declared "victory" in Gaza is legitimacy enough, Fatah's older guard seems determined to cling to its historic dominance of the Palestinian national movement. Hamas also demands the release of scores of its members held by Mr Abbas's police in the West Bank, while Fatah insists on keeping control of foreign affairs, including peace dealings with Israel.

The influence of foreign governments has not helped reconciliation. Western ones, along with Arab allies such as Egypt, Saudi Arabia and Jordan, still prop up Mr Abbas and shun Hamas, arguing that it could win acceptability simply by giving up its declared aim of destroying Israel by armed struggle. The rejectionist front—Iran, Syria and milder sympathisers such as Qatar—has done the opposite.

Israel, which clamped an 18-month siege on the territory following Hamas's takeover, has opened the valves a notch to let in immediate aid, but signals that it will still impose stringent terms on the supply even of such goods as cement, which Israel says can be used to build rocket-launching sites. Egypt, whose rulers loathe Hamas as the Palestinian sibling of its own troublesome Muslim Brotherhood, and control the only other border with Gaza, still insists that it be sealed until Hamas lets the PA or international monitors take it over. Egypt has also pledged to ensure that hundreds of smuggling tunnels hit by bunker-busting Israeli bombs stay blocked. European and Arab donors, including Saudi Arabia, whose king has pledged $1 billion in aid to Gaza, say they will work through any party to deliver it—except for Hamas.

The Islamist party is looking forward to a windfall of aid from its own backers, including Iran. Qatar has proffered $250m. Hamas, much like Hizbullah, the well-armed Shia movement in Lebanon after its war with Israel in 2006, is already upstaging slow-moving international donors by giving cash to needy Gazans. Hamas officials still demand a complete and unconditional opening of all access points into the territory, and say the most they will offer Israel is a limited *hudna*, or truce. "There is no end to this," says Yusuf Ashrafi, a Hamas leader in Gaza. "We are not just fighting for food to be brought in, but for al-Aqsa [the mosque in Jerusalem that is Islam's third-holiest site]."

Can Hamas compromise?

Hamas's claims of "victory" may strike many shell-shocked Gazans as otherworldly. Its leaders face a tough choice. They can settle for a controlled opening, perhaps under international inspection, that would hinder rearmament but relieve ordinary Gazans. Or they can keep trying to embarrass Egypt and to shoot at Israel, so as to keep the "resistance" alive.

A flurry of summit meetings followed the ceasefire on January 18th. While Qatar summoned Hamas figureheads and their backers, including Iran's president, Mahmoud Ahmadinejad, to hail the resistance and demand an end to peace overtures to Israel, Egypt and Saudi Arabia hosted counter-meetings to bolster Mr Abbas. At a later Arab summit that brought both lots together, a joint platform could not be agreed on, though King Abdullah, hoping to steer a middle course, declared that an Arab initiative to recognise Israel in exchange for its withdrawal from Gaza and the West Bank, which all the Arabs signed in 2002, could not stay on the table for ever.

In the meantime, moves to consolidate the ceasefire continued. Egypt hosted separate delegations from Israel and Hamas in a sign that, despite the opprobrium it has earned from many Arabs by its support for the blockade, Egypt still monopolises most channels of communication.

On his first day in office, Barack Obama telephoned Mr Abbas as well as Israel's Ehud Olmert. His reported selection as Middle East envoy of George Mitchell, a former senator of part-Lebanese descent

with experience as a peacemaker in Northern Ireland, was generally well-received. But no one thinks that trying to make peace between Palestinians themselves, let alone among Palestinians and Israelis, will be anything but gut-wrenching.

The Gaza Strip

Back to a kind of life

Jan 22nd 2009 | GAZA
From The Economist print edition

A shaken people still want an end to the siege, Palestinian unity, and peace

AS THE shops in Gaza City tentatively open in the morning, farmers start to bring in vegetables for the markets and vendors are back on the street, peddling the last of the Egyptian goods smuggled into the Strip before the Israeli assault began just over three weeks ago. In Rafah, the southern Gaza town nearest to the border with Egypt, repairs to the bombed-out tunnels are already under way. Some of the illicit plastic pipelines under the border that pump diesel fuel into Gaza are still operating, despite the vast displacement of sand.

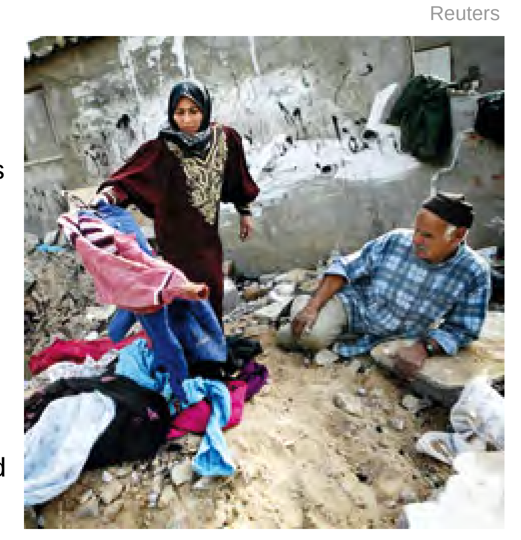
On street corners, Hamas police are back in uniform, flaunting their AK-47s. Thousands of people who sheltered in buildings belonging to the UN's Relief and Works Agency have returned home or, if their houses were destroyed, are staying with relatives. Outside a bank, people queue for their wages, since no payments were made during the fighting. Life is slowly returning to some kind of normality.

But the devastation of war is everywhere, the terrifying memory of it still raw. Sitting in the ruins of Zeitun, a district almost completely destroyed, Arafat Samouni painfully recounts the events that ended in the death of 30 members of his extended family in one of the war's most publicised tragedies. Still in shock, he struggles to remember the names of all the dead and how they were related to him. Asked whom he blames, he has no doubt. "The Israelis, of course. They knew this area. They knew there were civilians here." He refuses to blame Hamas. Nor will he judge the outcome of the war. "I can't say who won. I just don't know," he says, as he gloomily rubs his red face.

If "shock and awe" was the Israelis' intention, it worked—to the extent that the trauma is plainly visible in people's faces. Three nights after the truce was announced on January 18th, Gaza City's streets are still empty. People flinch at the sound of sudden noise. A recent declaration by Hamas's prime minister, Ismail Haniyeh, that the movement has won a great victory draws mirthless smiles.

But many faithfully stick to the official version. "The resistance did very well," says Assad al-Hartani, a municipal worker as he shops for cigarettes in the market. "They stopped the invasion. Without them the Israelis would have destroyed all of Gaza." The fact that Hamas has not been ousted from power is itself considered a fine achievement. "Israel's war didn't change anything," Mr Hartani goes on. People in the crowd around him nod in agreement, albeit aware of two uniformed guards watching and listening.

Reuters



Can she rebuild?

In the streets you hear only support for Hamas. In more secluded conversations, views are more nuanced, with expressions of anger, fear and exhaustion. "People are furious with Hamas for bringing this on us," says a taxi driver from Jabaliya, a big refugee camp in the north of the strip, after first making sure that the car windows were closed and no one was eavesdropping. "But they are too afraid to speak out. They know that if they say the truth about this war they may disappear."

But he also describes how people's feelings changed as the war went on. At first, some were delighted by the prospect of Hamas's demise. But after days of bombs, sentiment shifted. "The Israelis made a mistake when they killed so many women and children. Everyone then supported Hamas. The Israelis made a big mistake." He repeats that last phrase several times.

Some Gazans grumble about the Hamas forces' poor performance. Despite their promises to slaughter the Zionist invaders, they barely dented the Israeli military machine. Of Israel's 13 army and civilian

fatalities in the three-week campaign, the Israelis acknowledge only six soldiers directly killed by Hamas—and claim to have killed hundreds of Hamas people. The Islamist movement's Qassam Brigades say they killed 49 Israelis and lost 48 of their own men. "That's just talk," says a Jabaliya man. A backer of Hamas's secular rival, Fatah, smiled when he compared this war in Gaza with Israel's incursion into the West Bank in 2002. "In Jenin, 53 Palestinians were killed and 23 Israeli soldiers," he said, noting that the battle was fought there by Fatah's armed wing.

Even those who refuse to blame Hamas want some sort of peace deal to let them think that all the death and destruction was not for nothing. Many say a proposed year-long ceasefire is not enough. Their main desire is for the borders to be opened and for the economic and physical siege to be lifted. "My brother's wedding is in Cairo on Friday," says a Gazan waiting at the still-closed Rafah crossing. "I want to be there."

And many Gazans want the two main Palestinian factions to end the strife between them. But some Fatah people note sourly that Hamas refused to give them their guns back, even to fight the invading Israelis. What if Palestinian disunity persists and the borders stay closed? "Then there will be another war, of course," says a Hamas guard. "We have no choice."

And could the new American president bring peace? "We never had an American president who thinks for himself," says a man munching water-melon seeds in the Abu Nabil coffee shop near the Rafah border. "They all just follow the Israelis." Is there no comfort in Mr Obama's Muslim middle name? "That's all it is, a name."

Israel after Gaza

Counting the cost

Jan 22nd 2009 | JERUSALEM
From The Economist print edition

Israelis begin to ask whether the war in Gaza was worth it

AP



Happily home—but was the job done?

AFTER pounding Hamas and the Gaza Strip for three weeks, the last of Israel's troops withdrew from the territory on January 21st, leaving some 1,300 Palestinian dead, probably more than half of them civilians. Israel lost just ten soldiers (four in accidents) and three civilians. Armoured units stayed on the Gaza border, poised to go back in, the army said, if Hamas resumed its firing of rockets across the border. But a post-war debate, three weeks before a general election on February 10th, is already hotting up. Was the war worth it?

Some argue that the army did not do enough, others that it did far too much. A broad swathe of public opinion, still favouring the war, now seeks assurance that it has indeed "changed the reality" in the border region, as the government originally promised, to stop the stream of desultory rocket fire from inside the strip that had killed a dozen Israelis in more than three years and wounded many more.

The government scrambled to give that assurance. Ministers said that Egypt was more serious than before about stanching the supply of missiles from Iran to Hamas. Egypt would now act effectively to stop arms-smuggling under its border with Gaza through the warren of tunnels, many of which Israel's bombs have at least temporarily blocked.

The Americans have promised more vigorous co-operation with NATO and countries in the region to halt the arms flow to Hamas, "including through the Mediterranean, the Gulf of Aden, the Red Sea and eastern Africa". The heads of five leading European governments plus the EU's current president, a Czech, visited Egypt and Israel to stress their determination to stop Hamas rearming. Britain and France offered naval patrols, Germany technical help to monitor the tunnels.

Getting reconstruction aid into Gaza will be tricky. Ehud Olmert, Israel's outgoing prime minister, urged the UN's secretary-general, Ban Ki-moon, to channel all such aid exclusively through the Palestinian Authority, which is run by Hamas's rival, Fatah, headed by Mahmoud Abbas. This was the message, too, that the foreign minister, Tzipi Livni, took to a meeting with EU foreign ministers in Brussels.

Israel's government also hopes to wrest the return of a kidnapped soldier, Gilad Shalit, as part of a post-war package of understandings negotiated through Egypt. "Hamas wants the border crossings opened," said Ms Livni, "but they have something we want: Gilad Shalit." Israel is hinting it would trade hundreds of Hamas prisoners for Corporal Shalit but is balking at some of the names Hamas wants freed.

For the right-wing opposition all this is futile. After a lull in electioneering while the fighting lasted, Binyamin Netanyahu, who leads the opposition Likud, now loudly accuses the government of squandering the chance offered by the army by stopping the war too soon. (All parties praise the army itself, amid general gratification and relief that its ground troops fought well, especially compared with their poor performance against the Lebanese Shia militias of Hizbullah in south Lebanon in 2006.)

Avigdor Lieberman, the hardline head of a mainly Russian-immigrant party, Yisrael Beitenu, remarked pointedly that when Russia and Georgia stopped fighting last year "no one was in doubt about who had won and who had lost". To impress his potential voters even more, Mr Lieberman threatened two Arab members of parliament that he would "deal with you as we dealt with Hamas".

A less strident and more respected figure on the right, Moshe Arens, a former defence minister, says Israel's failure to eliminate Hamas's rocket-launching capability "means we're pretty much in the same situation". On January 19th, the last full day of fighting, Hamas fired 19 rockets into Israel. He dismissed the claim that Hamas had "learned its lesson" and would be deterred from firing at Israel in the future.

"Deterrent credibility" restored?

Mr Olmert, announcing a unilateral ceasefire, followed 12 hours later by a matching one by Hamas, said the Palestinian group had been shocked by Israel's readiness to attack its fighters in civilian areas. Ms Livni spoke in similarly approving terms of Israel's "wild reaction" and "bully-boy behaviour" in response to Hamas's refusal to stop firing rockets into Israel. Hamas and others in the region, she said, had "learned and understood" that Israel would not countenance such continuous violation of its borders and the targeting of its civilians.

But Israel's left, which at first gave unusually solid support to the Gaza operation, is growing edgy as the extent of the carnage is conveyed in Israel's media. The army says it is preparing detailed evidence to show that Hamas booby-trapped residential homes, stored explosives in mosques and schools, and fired rockets and mortars from alleys and courtyards. It says it is launching its own inquiry into an episode involving phosphorus shells landing in a built-up area. But it has imposed strict censorship on the names and photographs of field officers who took part in the fighting, for fear they may be indicted or arrested on war-crime charges in foreign countries in the future. All told, it is questionable whether the governing parties will sustain their assertion that the Gaza operation was a brilliant success.

Iraq's elections

A real choice for the people

Jan 22nd 2009 | BAQUBA
From The Economist print edition

Hold your breath as a year of democracy begins

Reuters



Vote for the person as well as the list

BLAST walls that used to protect shop windows from car bombs in towns across Iraq are now covered in campaign posters, as candidates battle for votes ahead of test-case elections at the end of this month. These polls, for provincial councils, will measure the popularity of Iraq's main coalitions and point the way towards a general election due by the end of the year. The prime minister, Nuri al-Maliki, seems determined to run for a second term. This month's local polls will be his first proper electoral test since he took the top job two-and-half years ago.

Pictures of a smiling Mr Maliki, arm outstretched, are promoting his Shia party and several other groups that make up his ruling State of Law coalition, even though he himself is not actually a candidate. The coming polls will decide who sits on the councils that run 14 out of Iraq's 18 provinces. People in the autonomous Kurdish region's three provinces will not vote this time; those in the disputed province of Kirkuk (known in Arabic as Tamim) will cast their vote at a later date, so far undecided.

Better security since the last election, in 2005, means that candidates will for the first time have their name on the ballot and, if they choose, their face on campaign posters. Previously, people voted just for party lists. This time, with 14,400-odd candidates running for 440 council seats, turnout should be much higher, particularly as many Sunni Arabs who boycotted past polls in protest against the American-led occupation now plan to vote. So Iraq's second largest sectarian group is likely to weaken the grip that the Shia majority and the Kurds have enjoyed since the invasion.

In the rural province of Diyala stretching along the Iranian border north-east of Baghdad, tea-houses buzz with the chatter of men exchanging views on candidates as they play cards or backgammon and smoke waterpipes, in contrast to past ballots when violence deterred many people from daring to show an interest in voting.

In the darkest days of 2006, al-Qaeda in Iraq, the jihadist group that looks to Osama bin Laden for inspiration, named Diyala's provincial capital, Baquba, as the capital of its Islamist caliphate. It set up Islamist courts and prisons in the city; its masked gunmen controlled the streets.

But Omar Hassan, a 20-year-old law student, no longer worries about the jihadists, most of whom have been driven out of Baquba by American and Iraqi forces. Now he spends his spare time in tea-houses, playing dominoes and chatting about politics. "Some say, 'We must vote', while others say, 'We won't vote. What have the candidates done for us?'," says Omar. In the coming poll he will plump for his mother, Najat Khalaf Hussein, one of a growing band of women engaging in politics for the first time. Though a member of the Iraqi National Accord, a secular party led by Iyad Allawi, Iraq's first prime minister after the fall of Saddam Hussein, she expresses a rather religious view of politics, calling on divine intervention to fix such problems as patchy electricity and water supplies, high unemployment and war-damaged buildings. "Everything will become easy if God helps." She herself has had to pay for her posters on shop fronts, lamp posts and blast walls.

By contrast, candidates for the bigger parties, such as Mr Maliki's Dawa or its Shia rival, the Islamic Supreme Council of Iraq, which is probably the country's biggest Shia outfit, or the Iraqi Islamic Party, the main old-established Sunni one, have lots of cash, enabling them to festoon towns and even villages in the depths of the countryside with banners and billboards. They are expected to win the lion's share of

seats.

But the Constitutional Party, founded by Jawad al-Bolani, Iraq's powerful interior minister, a Shia, may also emerge as a force to be reckoned with. Campaigning on a secular platform, its posters hog prime spots in Baghdad and nearby districts with the words "Vote for Iraq's unity".

Candidates linked to the Sunni tribal *Sahwa* (Awakening), which helped the Americans pacify Anbar and other provinces, may also do well, challenging the dominance of the Islamic Party. Fans of a firebrand Shia cleric, Muqtada al-Sadr, who appeals to the poor, have no party to vote for, as his group was banned from the list on the ground that it maintains a militia. But voters will be able to tick the box of nominally non-aligned candidates backed by Mr Sadr's people. It will still be a big test of his popularity, especially in eastern Baghdad and areas of the south where his militias previously held sway. Mr Maliki is determined to cut Mr Sadr down to size.

Will sect and tribe still call the shots?

In past polls, Iraqis have tended to vote on sectarian or ethnic lines. Shia Arabs picked Shia parties, Sunni Arabs (if they voted at all) went for Sunni parties, Kurds for Kurdish parties, and so on. But more politicians and parties are trying this time to appeal across such lines, though it is still highly unlikely that, for example, a Sunni party will win many votes in a mainly Shia province such as Basra or that a Shia party would get many in Sunni Anbar, west of Baghdad. Corruption is a big issue: many Iraqis accuse the new establishment's politicians of enriching themselves while failing to provide basic services to the people.

Tribal loyalties are also bound often to influence voters more than candidates' individual merits, especially outside the cities. In the village of Saedah, a cluster of huts in a Sunni tribal area in eastern Diyala, only one candidate matters: Sheikh Mohammed Turki. "He is our sheikh and he is good for us,"said Muhammad Tarik Mahmood, a jobless 24-year-old villager.

As election fever mounts, so do allegations of dirty tricks, such as handing out telephone cards and cash tucked into election pamphlets. Supporters often tear down rival posters or disfigure portraits. Violent incidents have already occurred. A candidate from Mr Maliki's party in Baghdad has been killed. Many fear that violence may rise as election day draws near.

Another tricky factor is security at polling stations, especially in mixed areas such as Diyala, whose northern border abuts Kurdistan. Representatives of Kurds and Arabs, both trading accusations of voter intimidation, are locked in talks with American army officers over how to keep the peace. On polling day, January 31st, the Iraqi police and army will take the lead.

If the poll is reasonably peaceful, transparent and fair, it will mark a hugely hopeful step towards the general election at the end of the year, when, with American troops on the way out, Iraqis should come close, at last, to ruling themselves.

Correction: A war of words and images

Jan 22nd 2009
From The Economist print edition

In "A war of words and images" (January 17th), we said that a Rasmussen poll on Gaza showed that "while 44% of Americans were still for Israel, 41% were against it". In fact, the poll reported that 44% of Americans surveyed said that Israel "should have taken military action" but 41 % said it "should have tried to find a diplomatic solution." But 55% still believed that "the Palestinians were to blame for the situation in Gaza", whereas 13% pointed the finger at Israel. We also said in some copies that Samuel Joseph Wurzelbacher, an American who won celebrity in the presidential campaign as "Joe the Plumber", had been sent by Fox TV to report from Israel. In fact, it was Pajamas TV. Sorry, on both counts.

France

A time of troubles and protest

Jan 22nd 2009 | POISSY
From The Economist print edition

As European economies sink, fears of social unrest rise. This article looks at France; the next two at eastern Europe and Spain

AFP



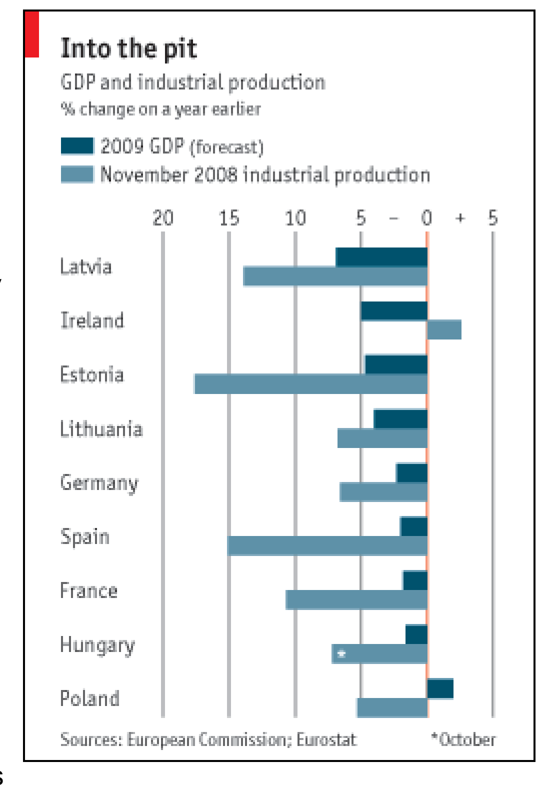
A FROSTY weekday at the end of the morning shift, and car workers are streaming out of the factory gate, coats buttoned up against the winter chill. But these employees, at the Peugeot car plant in Poissy, just west of Paris, will not be returning to work the next day. The factory is now operating short weeks, due to a slump in car sales. It shut down completely for four weeks over Christmas. And these workers are the lucky ones: they still have jobs, whereas 700 colleagues on temporary contracts have lost theirs. “There’s a real fear that redundancies could be next,” says Georges Martin, a union official who has worked here for 33 years.

The French may not be troubled by heavy mortgages or credit-card bills, but fears of unemployment are rising as recession takes hold. In November France’s jobless total reached 2.1m, an 8.5% rise on a year earlier. Other European Union countries such as Spain and Ireland are seeing even sharper rises in unemployment, as Europe’s economies head into what European Commission forecasts suggest may be their worst year since the 1970s (see chart). French unemployment, now 7.9%, could top 10% by 2010. Joblessness is growing fastest among under-25s, many of whom are being laid off as firms cut those on short-term contracts.

The government is most worried about the car industry, which directly employs 700,000 people in France (6,600 of them in Poissy), and indirectly 2.5m. This week François Fillon, the prime minister, told car-industry bosses that state help would go only to firms that kept production (and jobs) in the country. The Europe-wide concern that rising unemployment could provoke social unrest is particularly acute in France, where even in good times protesters take readily to the streets.

There have been various outbursts in recent weeks. When President Nicolas Sarkozy dropped in on a town in Normandy, the police had to use tear-gas to control a crowd of protesting students and teachers. Militant unions in Paris forced the closure

of a railway station, Saint-Lazare, for a day, and have paralysed public transport in Marseille. In December Mr Sarkozy postponed a school reform out of fears, prompted by riots in Greece, that French high-school protests could get out of hand and even set off a rerun of May 1968.



In the industrial town of Poissy, which grew up around the car plant that opened in 1938, there is a palpable sense of unease. “There is a lot of anxiety and stress, even depression, particularly among the young,” says Frédérik Bernard, the Socialist mayor. “When Peugeot is in difficulty, so is the town.” Some 400 temporary workers laid off at the factory live locally, and their chances of finding new jobs are slim. Even before the recession, France’s two-tier labour market overly protected permanent jobs and so prompted firms to hire only on flexible short-term contracts. These are the jobs, often held by the young, that are now being shed.

Could the jobs malaise translate into unrest? Two things cause concern. The first is the student movement, which in France includes high-school unions. Many politicians on the left emerged from student politics, which at university level is a potent lobby. Campus sit-ins in 2006 forced the then government to back down from a proposed flexible job contract for the young. Mr Sarkozy is even more worried about high-school unions. They are more unpredictable, and more easily influenced by hard-left or anarchist groups, or by teachers, who lose pay for days on strike and so prefer the students to come out instead. Should trouble break out in France, or elsewhere in Europe, there will be genuine fears of contagion.

Up on the hill above Poissy, opposite a rain-streaked low-rise housing estate, the Lycée Le Corbusier was periodically blockaded by pupils last autumn, as part of the countrywide protests that forced Mr Sarkozy’s climbdown. The students are against cuts to teaching staff, as well as a proposed new curriculum. But at Le Corbusier they are quick to point out that the reform has been postponed, not dropped. Pauline Jagu-David, a student leader who packs flyers alongside economics textbooks in her bag, says that students are still angry. “We know we’re a strong force, and that we frighten the government.”

The second cause of unease is the rise of a militant union, Solidaire Unitaire Démocratique, or SUD. Loosely linked to hard-left Trotskyist and revolutionary communist groups, it belongs to a tradition that the French call *anarcho-syndicalisme*. It is anti-establishment, not being one of the five official unions that deal with the government. It is non-hierarchical and has no official leader. Yet, with a strong following among workers for the SNCF rail company, where it is the second-biggest union, and a deft ability to find loopholes in the law, it has disrupted train services into the Gare Saint-Lazare for weeks, affecting hundreds of thousands of angry commuters. Ahead of internal company elections to works councils this March, it is keen to make its voice heard, cause trouble and recruit support.

One of SUD’s feats is to have made the Confédération Générale du Travail (CGT), France’s powerful communist-backed union, seem moderate. In the café next to the car factory in Poissy, CGT officials, their blue union jackets over grey Peugeot overalls, outline proposals to management on pay and working practices. “They are using the crisis as an excuse to cut pay and intensify the workload,” says Farid Borsali, the CGT general secretary at Poissy. He is scandalised that the government is handing money to banks when workers’ pay is stagnant. But the union is organising nothing more sinister than buses to take workers to join a national day of action next week.

Such organised protests are meant to be peaceful. French public opinion is not behind radicals such as SUD. Callers to radio talk-shows during the one-day station closure were furious, pointing out that the union had the luxury of combining troublemaking with public-sector job security. But as the recession bites, the chances of rallying disparate protest groups around an anti-capitalist ideology could rise. In Poissy the CGT’s Mr Martin is glum. “You saw what happened in Greece,” he says darkly. “There’s a social bomb waiting to explode here too.”

East European economies

To the barricades

Jan 22nd 2009 | VILNIUS
From The Economist print edition

Economic pain brings political ructions

IN INTENSIVE care but angry: that describes Latvia's economy after its dramatic rescue by the IMF and other foreign lenders. Now the question is whether the tough conditions imposed by the bail-out are politically tolerable. A riot in Riga, in which more than 40 people (including 14 police officers) were hurt and 106 arrested, suggests there is a bumpy ride ahead.

Latvia, a country of 2.4m that may soon be the sixth-biggest debtor to the IMF, is not alone. Lithuania has pushed through similarly tough wage and spending cuts and tax rises. A protest on January 16th turned violent, with protesters pelting the police with snowballs and stones. After a decade in which breakneck growth made up for political weaknesses, pessimists fear that the post-cold war settlement across eastern Europe may now be at risk.

That settlement rested on three notions. One was that Western-style politics was both trustworthy and efficient, in contrast to the failures of communism. The second was that welfare capitalism and integration into Western markets would produce prosperity. And the third was that joining the European Union would provide a guarantee of economic and political security. All three now look wobbly.

In 2006 Latvia's economy was still growing by an astonishing 12% a year. One reason was that locally owned banks—comprising some 40% of the financial system—took deposits from foreigners (chiefly Russians) and invested in an increasingly frothy property market. The government not only failed to supervise them properly. It also inflated the bubble by running a loose fiscal policy.

The biggest local bank, Parex, collapsed and has been largely nationalised. Outsiders going through the books are finding much to be glum about. At worst, the Latvian taxpayer faces a bill of up to $3 billion. Even at best the country faces several painful years as it tries to regain competitiveness. Such pain may have been tolerable after 1991 when problems could be blamed on communist times. Nobody knows where public anger will focus now.

The IMF and others believe that the best solution would have been immediate devaluation of the national currency, the lat, accompanied by its replacement by the euro. That would have hurt the many households and businesses that have borrowed in foreign currency. But calculations published by the IMF suggest that the recovery thereafter would have been quicker and steeper.

AFP

Yet euroisation has proved impossible. The European Central Bank and the European Commission were unwilling to change their rules. And the overwhelming consensus in Latvia favours keeping the lat's currency peg. Neither the protesters in Riga nor opposition politicians want a devaluation. Their most controversial demand is for a progressive income tax (Latvia, like its neighbours, has a flat tax).

Ainars Slesers, the transport minister, is suggesting legal action to protect creditors of the Nordic-owned banks that make up most of the rest of the financial system. He blames their irresponsible lending for stoking the boom. Yet it is only foreign banks' willingness to stump up for their losses that is keeping Latvia afloat. Shares in Nordic banks such as Swedbank and SEB have plunged because of worries about their exposure to bad Baltic loans.

Latvia's prime minister, Ivars Godmanis, is widely seen as a competent heavyweight. But he depends on powerful political barons such as Mr Slesers to support his governing coalition. The president, Valdis Zatlers, wants a cabinet shuffle to dump discredited figures. Failing that, an early

election in the summer looks likely. Yet Latvia's opposition parties are a motley lot; and no policy mix can now avoid economic pain.



Who is responsible for my pain?

Most other east European EU members are in a better way, at least for now. Estonia was more prudent during the boom, building up net public assets equivalent to 7% of GDP. It can now run an expansionary fiscal policy that offsets the recession, rather than a tight one that aggravates it, as in Latvia and Lithuania. Estonia's banks are almost all foreign-owned. Even Lithuania's dodgiest local bank is nothing like as troubled as Parex in Latvia.

Not that the foreign-owned banks are in great shape. Across the region cash-strapped banks are cutting business loans, worsening the downturn. No international or national institution has the authority to deal with banks that take deposits in one country and lend in another, often with managers in a third country and shareholders in a fourth. Neither the IMF nor the ECB is set up to deal with these beasts.

The biggest concern is how far the economic weakness will spread. Poland, the biggest regional economy, has looked fairly safe. The central bank has even cut interest rates sharply, after raising them in 2008. But industrial production is plummeting, with inevitable effects on tax revenues. By the summer the government will have to choose between maintaining a tough fiscal stance (a condition for joining the euro) and easing the pain of recession. At least Poland has a choice. Hungary, the most indebted country in the region, has little option but to tighten its belt further.

Governments normally respond to recession by loosening fiscal policies to preserve jobs and output. But most in eastern Europe cannot do this. Their debts make it hard to borrow more. Currency pegs in the Baltics and Bulgaria that once seemed to offer stability and a smooth path to the euro now put the burden of adjustment wholly on wages and output. The voters, many of whom suffered gas cut-offs in Russia's gas spat with Ukraine, won't like it. What will they do? Nobody knows.




Spain's new unemployed

And worse to come

Jan 22nd 2009 | MADRID
From The Economist print edition

The worrying social fallout from sharply rising unemployment

TENS of thousands protested in Zaragoza recently. “If this isn’t fixed, strike! strike! strike!” they chanted. A city that in 2008 enjoyed the limelight of a World Expo is now one of Spain’s most troubled. The protesters show that negative indicators are more than mere numbers. In the country with Europe’s highest unemployment rate, jobs have overtaken terrorism as voters’ main concern.

In few places does the social fallout from recession look so dramatic. Predictions keep getting worse. The government expects unemployment to rise from 13% to 16% this year. The ESADE business school predicts 20%. Aragón, the region of which Zaragoza is capital, encapsulates it all. The switch from boom to bust has had a drastic effect. Spain’s decade of high growth was especially notable in Aragón, which hit near-full employment in the Expo-building frenzy. “Now we are among the regions destroying jobs fastest,” says Julián Buey, a local union leader. “That is because we created low-skilled work in construction but did not invest in technology.”

The end of the Expo and the car-making crash make things worse. Aragón’s government, desperate to save a General Motors factory and its suppliers, has offered GM a €200m ($260m) credit guarantee. It is fighting an uphill battle. Spain is leading car sales down with an annual drop in demand of almost 30%.

The pain is uneven. Immigrants and the young, many of Aragón’s new workers, were the first to be sacked. They have not built up a decent cushion of unemployment benefit. Some 5m foreigners have multiplied Spain’s immigrant population eightfold in a decade. Offering them lump-sum payments to go home has not worked. Many young people dropped out of school because jobs were plentiful, says Mr Buey. Now they are both unemployed and uneducated.

The government in Madrid predicts that GDP will contract by 1.6% this year, and the budget deficit will soar to 6% of GDP. Others are even gloomier. “We have used up all the leeway we had with public spending,” admitted Pedro Solbes, the finance minister. Standard & Poor’s decision this week to downgrade Spain’s credit rating has confirmed the worst.

The full social impact of the recession will kick in after the summer, when a first wave of jobless run out of unemployment pay and start receiving less generous welfare handouts. The Socialist government of José Luis Rodríguez Zapatero, which was re-elected in March 2008, may then feel more popular discontent. For now claims that things will be rosier at year’s end may have lulled some into a false sense of security. Spain’s strawberry farmers, in need of pickers, have gone to Morocco to hire thousands of labourers this month. Spaniards had it good for so long that many will not consider low-paid agricultural work. That may change by the time the strawberries need picking again next year.

Russian political murders

Deaths in Moscow

Jan 22nd 2009 | MOSCOW
From The Economist print edition

Political killings have become systematic in Russia. Their punishment has not

ON MARCH 26th 2000 Vladimir Putin was elected president of Russia. By coincidence his election, partly promoted by the war in Chechnya, was soiled by a horrific crime that same night. A Russian colonel, Yuri Budanov, entered a house in the Chechen village of Tangi, home to an 18-year-old girl, Elza Kungaeva. Mr Budanov ordered his soldiers to wrap her in a blanket, put her in his armoured personal carrier and take her to his quarters.

Two hours later she was dead, her strangled naked body displaying marks of severe beating. She was buried in secret but an autopsy later showed that she had been raped and sodomised. After a three-year legal odyssey, Colonel Budanov was sentenced to ten years in prison for the murder. A rare case of a Russian officer being brought to justice for a wartime crime in Chechnya, it became a symbol of the army's atrocities there.

On January 15th Mr Budanov was freed on parole for good behaviour, 18 months early. Stanislav Markelov, a lawyer for the Kungaev family, protested vainly against his early release. On January 19th Mr Markelov held a press conference, claiming that Mr Budanov was freed only after a false statement by the prosecution service.

After the news conference, Mr Markelov walked towards a Moscow metro station along a busy street, accompanied by Anastasia Baburova, a 25-year-old journalist for *Novaya Gazeta*, one of Russia's most daring remaining independent newspapers. A masked man following behind shot Mr Markelov dead. Ms Baburova chased the killer; he turned and shot her in the head, and she later died. It was about 3pm, barely a mile from the Kremlin. Even by Russian standards this was brazen.

Mr Budanov denied any involvement. Mr Markelov had defended many victims of human-right abuses, in Chechnya and elsewhere. He was particularly hated by Russia's nationalists and neo-fascists, for whom Mr Budanov is an idol and a cause célèbre. (Ms Baburova had written about just these groups in her newspaper.)

AP



Flowers for a human-rights defender

As Mr Markelov argued in his final news conference, Mr Budanov's release reflected neither his own interest, nor the state's. "It was in the interest of those who seek to undermine legal institutions in the Caucasus," he said. Jailing Mr Budanov was a way to show Chechens that they could seek justice peacefully rather than turning to separatists for revenge. His release argued the opposite.

In Chechnya, it was seen as yet another sign of Moscow's contempt. Even Ramzan Kadyrov, the republic's pro-Kremlin president, was outraged. The killing of Mr Markelov eliminated a man whose name in

Chechnya, according to Tatyana Lokshina of Human Rights Watch, a campaigning group, “was synonymous with hope for justice.” It also epitomised the atmosphere of lawlessness and impunity that has flourished in Russia in recent years.

The list of dead journalists, campaigners for civil liberties and those who seriously harm the interests of over-mighty state officials is getting longer by the day. On January 13th a former Chechen rebel, Umar Israilov, who had turned against Mr Kadyrov and formally complained to the European Court of Human Rights of his involvement in kidnappings and torture, was gunned down in Vienna.

Last August Magomed Yevloyev, a journalist and owner of an opposition internet site in another north Caucasus republic, Ingushetia, was detained and “accidentally” shot by an interior ministry guard. His supporters blamed Ingushetia’s then president and interior minister. To the joy of the whole republic the Kremlin fired both men in October. But on December 30th Russia’s president, Dmitry Medvedev, appointed the former interior minister to a new job of “federal inspector” in Moscow. Impunity, it seems, still prevails.

Mr Putin prides himself on having pacified Chechnya. The war is indeed over, but its legacy continues to poison and haunt Russia. Its methods have spread far beyond Chechnya to reach Moscow. In a recent road-rage incident in the Russian capital, two Chechen policemen bearing special security passes beat up and fired at a bus driver who cut in front of their Mercedes.

Mr Medvedev once pledged to fight “legal nihilism” in Russian society. But neither he nor Mr Putin has uttered a word about the killing of Mr Markelov and his brave companion, both of whom tried to defend the law from the abuses of the state.

Hesse's election

A strange liberal revival

Jan 22nd 2009 | BERLIN
From The Economist print edition

The Free Democrats have done unexpectedly well in Hesse

A FEW campaigns ago Guido Westerwelle, leader of Germany’s liberal Free Democratic Party (FDP), sported shoes with the number 18 etched in the soles. The party did not win that share of the vote and the shoes were retired. But on January 18th the FDP came close, taking 16.2% of the vote in a state election in Hesse. It will now enter the state government as junior partner of the Christian Democratic Union (CDU)—a feat it hopes to repeat at federal level after the German election on September 27th. In the meantime the FDP, now in opposition to the ruling grand coalition between the CDU and the Social Democratic Party (SPD), will have extra clout.

Its strong showing at a time of economic woe seems puzzling. “Neo-liberalism” is widely blamed for the crisis; the government is responding by boosting spending and bailing out business. The FDP’s preference for private over state seems unfashionable. Not so, say its leaders. In hard times voters worry more about sustaining growth than about distributing its fruits. They trust parties from the “bourgeois camp”—the FDP and the CDU—more than those on the left. Liberal ideas like lower taxes and less bureaucracy are economic cures. The young embrace globalisation and personal responsibility. The FDP did well partly because the CDU, which barely raised its share of the vote in Hesse, has wavered over such principles. “The FDP’s future as a small party is endangered,” beams Hermann Otto Solms, its Bundestag point man for fiscal policy.

Perhaps. Yet part of the lift in Hesse came from local factors. Voters punished the SPD for a botched attempt to rule in Hesse with the backing of the Left Party, which has its origins in East Germany’s communist party. Nor do they much like Roland Koch, the CDU state premier. The combined result of the two big parties was the worst in a western state in nearly 60 years, continuing a decline speeded up by their awkward power-sharing at federal level. Even so, stable support for the FDP is “not more” than a tenth of the electorate, reckons Wolfgang Merkel, at the Social Science Research Centre Berlin.

Yet it could be an all-important tenth. The FDP is in coalition with the CDU (or its Bavarian sibling, the Christian Social Union) in five states, with over half of Germany’s population. After the Hesse election the grand coalition will lose its majority in the upper-house Bundesrat. The chancellor, Angela Merkel, has warned the FDP not to “overreach”. (The FDP wants changes to the government’s stimulus plans but lacks the votes to impose them.) The Hesse results suggest that, even in a five-party system, the CDU and the FDP can hope to rule together so long as the SPD remains weak.

The two parties say they have more in common with each other than with other parties. But their differences have widened under the grand coalition. The FDP fumes that the CDU has yielded to social democratic initiatives such as the creeping introduction of a minimum wage. It wants to liberalise the labour market and replace social transfers with a sort of negative income tax, says Mr Solms. Criticised for pandering to business, the FDP has begun talking up its traditional defence of civil liberties. Never has there been “such a dramatic dismantling of civil rights” as in the past eight years, Mr Westerwelle has said.

The FDP helped to rule Germany with minor interruptions until 1998, swinging between the CDU and the SPD. It yearns to be back in power (Mr Westerwelle would like to be foreign minister). If it gets there, its liberalism will be tempered by its partner, whichever party it is. The triumph in Hesse may be a first step.





Charlemagne

Iceland hunts the euro

Jan 22nd 2009
From The Economist print edition

Why a crisis-hit Iceland may apply to join the European Union as soon as March

Illustration by Peter Schrank



FOR a small country, Iceland has room for lots of contradictions. Some can be seen in the harbour of Reykjavik, the trim capital. On one side of the Aegisgardur pier lie whale-watching boats that take foreign tourists to commune with whales, dolphins and puffins. But just across the pier are four large ships, with mysterious gantries and winches above their decks: whalers, their harpoon guns in storage as the government ponders allowing a commercial hunt. Iceland's stance on whaling is ambiguous: it opted out of an international moratorium, but the most recent big hunt was in 2006. Some fishing bosses support catching whales: there are plenty of them, they say, and they eat fish. Activists say whales are intelligent, scoffs Kristjan Loftsson, boss of the whaling fleet. His family has been hunting fin whales in the same spot since 1948, "and they still come there to eat". If whales went farther offshore, they would not be caught, he adds, as their large carcasses might rot on the journey back.

Ambivalence about whales mirrors larger tensions. Iceland—three times as big as Belgium, but with only 300,000 inhabitants—has full access to the European Union's single market through the European Economic Area (EEA). Its citizens can live and work across the EU, and it is assiduous about implementing directives from Brussels. But most of its leaders have always been hostile to full EU membership: they prize their sovereignty (Iceland became independent from Denmark only in 1944) and fear foreign control of their fish.

EEA membership has been good for Iceland, which pays relatively little into EU funds, and runs its own farm and fish policies (it also escapes EU laws banning whaling). Yet the EU debate has been revived by the collapse of Iceland's economy after its debt-fuelled boom. Above all, the Icelandic krona is barely traded now: banks cannot borrow abroad, and capital controls block investment flows. A large majority of Icelandic voters want a new currency. Given trading patterns, the euro makes most sense.

What happens next revolves around a congress next week of the ruling Independence Party, a broad centre-right coalition hostile to EU membership. The prime minister, Geir Haarde, remains a Eurosceptic. But he also knows that the Icelandic krona is "finished", says an observer. Hardliners have called for unilateral adoption of the euro (or maybe the dollar, Swiss franc or Norwegian krone). But Mr Haarde has been told by EU bosses that unilateral action without the boring necessity of joining the EU first would wreck relations with Brussels. And an open letter, signed by 32 Icelandic economists, gave warning that it would not even provide Iceland with what it needs: international credibility as a normal developed state. Mr Haarde agrees, say officials.

Which leaves him pondering EU membership after all—and trying to preserve party unity. Mr Haarde is "not a decisive man", and will try to keep his options open at the congress. Talk of a referendum on opening EU talks briefly tempted him. He may now prefer a committee to review options (with strong caveats over fish) and discussions with his coalition partners, the pro-EU Social Democrats. The Social Democrats say they will quit the coalition if an EU membership application is not lodged by March. But they have as much to fear from a snap election as Mr Haarde (a tide of protests suggest the big winner might be the Left-Green Movement, which denounces the EU as too capitalist). In short, the government may end up stalling for time.

Unfortunately, Iceland does not have time. The European commissioner for enlargement, Olli Rehn, is a strong ally. A Finn, Mr Rehn says that Iceland "would complement the EU, both philosophically and economically". Its strict fish-management policies have been praised by the fisheries commissioner, Joe Borg (who is from Malta, a small island that has no selfish interests in cod). But there will be a new European Commission in the autumn. To catch both Mr Borg and Mr Rehn in their current jobs, an application must go in by April at the latest. The commission could rush through a formal positive opinion in six months (Iceland already applies two-thirds of EU laws). Iceland could then become a formal candidate in late 2009, when Sweden (another ally) holds the rotating EU presidency, and a full EU member by 2011. Membership of the single currency would take a bit longer, but pro-EU politicians say the simple act of applying and working towards euro convergence would reassure the markets.

Dangerous shoals ahead

As time passes, Iceland's chances may shrink. Sweden will be followed in the presidency by Spain, a country with a prodigious appetite for others' fish. Then comes federalist Belgium, which may feel Europe has enough sceptical Atlantic islands already.

Icelanders fear the EU wants to grab some of their fish through the common fisheries policy. Such fears are "exaggerated, but not wholly unjustified", admits one Eurocrat. If Iceland wants the euro, it may have to "move a bit" on fish. (Greenland and the Faroes, nearby Danish dependencies, control their own fish, but neither is an EU member.) Exemption from the fisheries policy is a non-starter, not least because future applicants might seek the same. But Iceland may win transitional arrangements, perhaps along the lines of national subsidies permitted for far-northern Finnish and Swedish farms.

Will such a fudge do it? Icelanders are fond of national myths of splendid isolation, says Arni Pall, a Social Democratic member of parliament. But they are also deeply pragmatic. Just consider whale hunting, he suggests. Icelanders grew up thinking of whaling as normal, but whaling offends public opinion abroad and harms lucrative fish exports, so it is now stalled.

Iceland will be bullied, in subtle and unpleasant ways, if it applies to join the EU from its present position of weakness. Yet it may never have a better chance of a good deal. That sounds like a contradiction, but Iceland is good at managing those.



Rescuing banks

Shorn bank shares, shaven poll ratings, shredded nerves

Jan 22nd 2009
From The Economist print edition

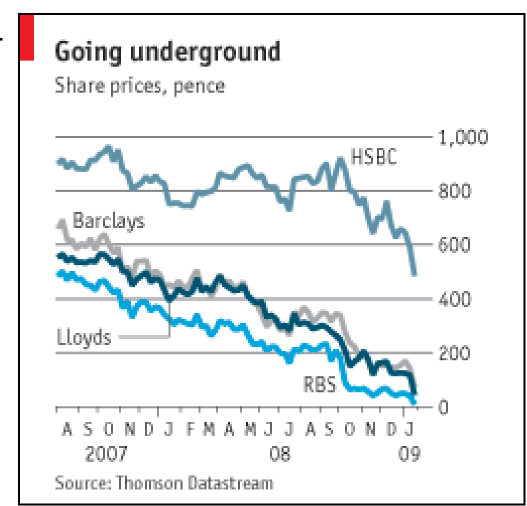
Plan B gets off to a bad start

XianPix



THREE months ago the British government led the world with its emergency measures to stave off a wholesale collapse of the financial system. As other countries adopted the same policy of recapitalising banks, Gordon Brown's reputation was burnished and his poll ratings enjoyed a startling bounce.

But if the prime minister was hoping to get another political lift this week as he announced a fresh initiative to help Britain's banks, he must have been disappointed. Their share prices turned to stone (see chart)—thanks partly to the expiry on January 16th of the ban on short-selling financial stocks—and sterling was battered as dealers worried about cross-infection between ailing banks and a sick economy.



The Treasury's new measures were wide-ranging. The Bank of England will set up a £50 billion ($69 billion) facility to buy private-sector assets such as corporate bonds and commercial paper. This will create a framework within which the central bank can conduct "quantitative easing"—creating money to buy assets—if that proves necessary. Northern Rock, a nationalised mortgage lender, will no longer seek to slash its mortgage book. The government will also encourage more lending by guaranteeing up to £50 billion in asset-backed securities. The Financial Services Authority helpfully said that the new capital recently injected into banks should be used both to withstand losses and to continue lending—though its chairman, Lord Turner, gave warning that in future banks would have to build up more capital in good times to prepare for bad times.

The heart of the Treasury's package was an "asset-protection scheme", a euphemism for dealing with the dodgy loans and assets that continue to hinder a return to banking health. Rather than setting up a "bad bank" to take these toxic assets off the banks' balance-sheets, the Treasury has decided to turn itself, in effect, into a catastrophe insurer. In return for paying a premium—and carrying the first chunk of any loss—banks will pass the buck for 90% of any further write-down to taxpayers.

Whatever the merits of this scheme in principle, clarity about how it would work in practice is not one of them. Specific information on the mechanics of the plan was sparse. This rattled the markets because it allowed unsettling speculation as to how big a bill might eventually be presented to the government and

taxpayers.

The need for some scheme to detoxify banks' balance-sheets was underlined by this week's thudding results from Royal Bank of Scotland (RBS), in which the government has a majority shareholding. RBS announced an expected loss of up to £28 billion, the biggest in British corporate history. Much of this consisted of accounting write-downs of goodwill, resulting from the bank's disastrous participation in the 2007 takeover of ABN Amro, a Dutch bank, but it also included a loss of £7 billion-8 billion in 2008.

More important still, something must be done to deal with the credit drought. Banks have cut overdraft facilities and unused credit lines, withdrawn from lending syndicates and abruptly called in loans. When they do lend, they are charging higher arrangement fees and interest at margins over their cost of funding that are considerably higher than they were.

Britain's economy needs its home-grown banks more than ever. Foreign lenders have largely left the British market. Investors of all sorts are frightened of securitised debt and anything in sterling. Banks in other countries, including America, Germany and Switzerland, are also reluctant to lend. But their national banking systems are less centralised than Britain's, where the choice of banks is growing ever more concentrated among a small group of relatively homogeneous institutions.

As the new rescue plan has attracted brickbats rather than plaudits, pressure is growing for the government to go the whole hog and nationalise the banks in which it has such a big stake. That would mark a U-turn. UK Financial Investments, the agency set up to run the government's shareholdings in the banks the state has taken over so far—Northern Rock, the asset book of Bradford & Bingley (both mortgage banks), 70% of RBS and 43% of Lloyds (the recently-merged Lloyds TSB and HBOS)—has been told to do its job at arm's length. Influential Labour MPs such as John McFall, the chairman of the parliamentary Treasury committee, are now calling for the full nationalisation of RBS and Lloyds.

But this debate, though it is pushing down share prices, misses the point. The crucial question is whether the insurance scheme should complement a more ambitious "bad bank" into which lenders' duff assets could be dumped. Such an approach would have the merit of clearly valuing and isolating them, thus freeing banks to move on. The insurance plan could then be deployed to encourage new loans by promising that, were a worsening economy to push them underwater, the government would share the pain.

And more pain there will surely be, as the unremitting drizzle of depressing economic news this week made clear. The number of people claiming unemployment benefit increased by 77,900 in December. The jobless rate, using a broader definition of those looking for work, rose to 6.1% of the labour force.

The public finances also deteriorated sharply as some of the costs of the recent banking rescues came into the official figures. Excluding the banking bail-outs, public-sector net debt now stands at 40.4% of GDP; if they are included, it is 47.5%. Borrowing has continued to balloon.

Yet Britain's starting-point was one of relatively low debt, at least compared with the other big G7 economies. Standard & Poor's, a credit-rating agency, reaffirmed on January 13th Britain's cherished AAA rating on its sovereign debt. For all the market jitters, the government retains the capacity to finance more bail-outs—which is handy, since it will certainly need to do so.

Robert Burns

Selling Scotland by the verse

Jan 22nd 2009 | EDINBURGH
From The Economist print edition

Testing the poet's pulling power

IN THIS especially bleak midwinter, what better excuse to have a drink and a knees-up than commemorating the birth of Robert Burns, the Scottish ploughman whose demotic verse was perhaps the first dialect version of English to achieve world literary and popular acclaim? The celebrations on January 25th this year will be particularly vigorous for they mark the 250th anniversary of the arrival of Rabbie, as Scotland's bard is known in his homeland.

Even in an off year, Burns suppers require much whisky-quaffing. Also compulsory is the eating of haggis, a concoction of minced offal, fat and oatmeal stuffed into a sheep's stomach (a BBC recipe's final instruction is "eat and then belch loudly or throw up"). Haggis-makers report record sales this year.

Inspired by the anniversary, VisitScotland, the national tourist agency, has set up a website inviting anyone holding a Burns supper to register it. Surprisingly, almost 1,200 are being held in England, more, it seems—as *The Economist* goes to press—than Scotland's roughly 1,000. The French, prepared to contemplate eating almost anything, report 33 Burns feasts. North Americans claim to be holding about 385 suppers, and there are several hundred more in countries including Russia, whose folk are no mean quaffers themselves, Jordan and Congo. The poet's soppy romanticism, flinty egalitarianism and ridicule of pomposity have universal appeal.

This all falls softly on the ears of Scotland's first minister, Alex Salmond. His devolved government has designated 2009 the "Year of Homecoming", and is spending £5m ($7m) on events and advertising to lure anyone with Scottish ancestry, or just a vague interest in the country, to pay a visit. He hopes an extra 100,000 tourists will spend some £40m.

Sadly, a survey published on January 20th by the Scottish Chambers of Commerce found that just 2% of tourist businesses expect an increase in demand this year and 76% foresee decline. Rabbie's lines may move people, but not enough to travel, it seems.

The return of Ken Clarke

The beast is awake

Jan 22nd 2009
From The Economist print edition

The former chancellor lights up a cautious Tory reshuffle

IT IS not hard to see how the Conservative Party's largely anonymous shadow cabinet could be improved by a recruit as famous and popular as Ken Clarke, the former chancellor of the exchequer and thrice-vanquished candidate for the Tory leadership, who returned to the front bench on January 19th. He has run some of the most unwieldy government departments, including health and the Home Office; of his new colleagues, only William Hague has run any. And his facility with economic jargon and concepts—the product of four successful years at the Treasury—is rare in a party that has often struggled to sound authoritative on the issue of the day.

But the fillip generated by the new business spokesman's appointment could be short-lived, some activists grumble. Mr Clarke promises to accept the party's Eurosceptic line, which is at odds with his own enthusiasm for the European Union, but that has yet to be tested. Even some who welcome Mr Clarke's return worry that the bluffness and jazz-filled hinterland that distinguish him from duller politicians also betray a personality unsuited to the dogged and thankless work of opposition. And if he proves a success, George Osborne, the shadow chancellor, who has been hurt by a recent brush with scandal and a perceived lack of heft, may be further cast in the shade. Gordon Brown, the prime minister, has already taken mischievously to calling Mr Clarke "the shadow shadow chancellor".

Neither does it seem an obvious time for a gamble by David Cameron, the Tory leader, who is usually at his boldest when he has little to lose. Three opinion polls this month have given the Conservatives a double-digit lead over Labour, whose resurgence peaked in December. And it is in any event hard to imagine Mr Clarke being as indispensable to Mr Cameron as Lord Mandelson, the business secretary and (it is said) "effectively the deputy prime minister", is to Mr Brown.

But even if the potential gains from Mr Clarke's return are perhaps exaggerated, so are the risks attached to it. Europe may not be a big issue again before the next election, after which Mr Clarke, now 68, may retire. Mr Osborne himself reputedly pushed for Mr Clarke's appointment. And if the Tories were unconvincing on the economy until lately, it was not for want of hard work; Mr Clarke's casual authority may be more effective than the slew of pronouncements attempted by Mr Cameron and Mr Osborne last year.

More plausible concerns surround the rest of Mr Cameron's shuffle, in which many Conservatives detect a softening of his reformist zeal. James Purnell, the work and pensions secretary, outflanked the Tories on welfare reform even when an ardent reformer, Chris Grayling, shadowed him. He will not find that task any tougher with Theresa May, a party stalwart but hardly a restless innovator on policy, as his new rival. Two of the Tories' best young thinkers, Greg Clark and Nick Herbert, are now in charge of a clutch of green issues; many want to see at least one of them carrying a bigger portfolio. And the new local-government spokesman, Caroline Spelman, who has swapped her old job of party chairman with the grassroots' beloved, Eric Pickles, is cooler on localism than some Tories would like.

With the Conservatives cautious on health policy for fear of seeming hostile to the adored National Health Service, and with scope for tax cuts curtailed by dismal public finances, Tory true-believers have only some market-based ideas for schools reform to get excited about. As Mr Clarke knows better than most, however, it is not necessary to be radical to be popular.

Public-service broadcasting

When just one BBC is not enough

Jan 22nd 2009
From The Economist print edition

The regulator wants a choice of quality viewing—but who should pay?

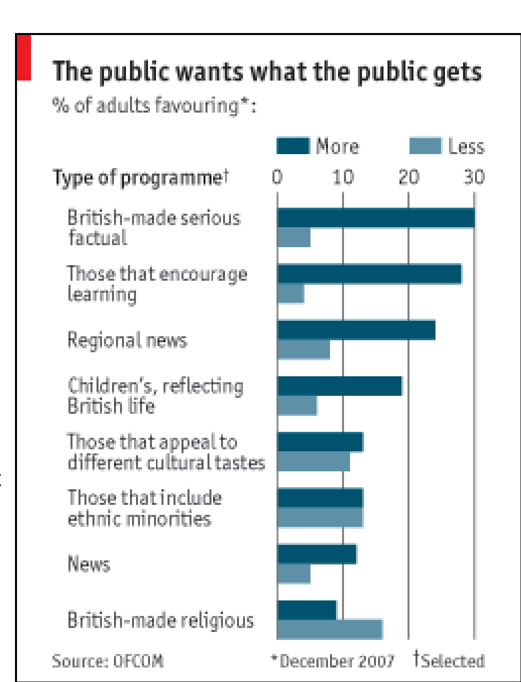
IT MAY surprise some viewers but Channel 4, the purveyor of “Celebrity Big Brother” and “Wife Swap”, is a public-service broadcaster. In pre-digital times, the three main commercial networks—ITV1, Channel 4 and Five—were obliged, in return for a chunk of scarce spectrum, to provide such worthy stuff as news and educational programmes along with their soaps and reality shows. Unlike the BBC, which is financed by a licence fee paid by British viewers, the other networks, even state-owned Channel 4, had to live by selling advertising space.

For decades, ad revenues were strong enough to pay for expensive but less-watched public-service programmes. So the benefits of having a public-service licence outweighed the costs. Now advertisers are fleeing to the internet and being forced by recession to slash their spending. Audiences are fragmenting as digital transmission provides space for many new channels, mostly free to show whatever programming they wish.

Ofcom, the broadcasting regulator, reckons that unless something is done soon, the three networks’ worsening finances may force them to hand back their public-service licences and join the race for ratings out in the digital jungle. The switchover to digital signal by 2012 means that multichannel choice will soon be available to almost all households. Public-service stations will enjoy few advantages over their obligation-free competitors.

This week Ofcom announced what it thinks should be done about this (the government is expected to give its views next week). Its research shows that people care more about some sorts of public-service programmes than others (see chart). The less popular categories, eg, religion, will be left to wither. As for those the public wants more of, such as regional news and serious factual programmes, the BBC makes plenty of them. But Ofcom says most viewers think the BBC should not be the only one. Competition must be kept alive, it argues, even if that requires taxpayers’ money.

So whereas Ofcom proposes to free ITV1 to chase ratings, it wants Channel 4 to become, essentially, a second BBC, taking on extra public-service obligations. It also thinks Channel 4 should secure its survival through a merger or joint venture. Already the broadcaster has spurned an advance from privately owned Five, preferring to marry the BBC’s hugely profitable commercial arm, BBC Worldwide. For its part the BBC wants to keep the Big Brother barbarians at arm’s length, offering Channel 4 only a limited “partnership” which might not close its future funding gap.



The BBC also says it will share production facilities with ITV1 so that ITV1 can maintain its regional news bulletins. Ofcom suspects, however, that in the end public finance may be needed, both to pay for ITV1’s regional news and to transform Channel 4 into a highbrow BBC clone. Ofcom has ruled out seizing a slice of the BBC licence fee to pay for all this, arguing that it would endanger the quality of BBC programmes. Toby Syfret of Enders Analysis, a consultancy, argues that the BBC’s heavy spending is in fact bidding up the cost of presenters and programmes, making it harder for Channel 4 and the other networks to survive. But if these are now given taxpayers’ money to take on the BBC, this will in turn make survival even harder for local newspapers. Some MPs are proposing handouts for them too.

Another solution—one that is far more pro-competitive than propping up state-financed stooges—is to tell

viewers that if they really want a second provider of regional news and the like, they will have to pay for it through subscriptions. But Ofcom's boss, Ed Richards, argues that if you believe in public-service broadcasting you have to believe in making it free for everyone. A noble sentiment, but the government surely has more pressing demands on its finances.

Private education

Rock or hard place?

Jan 22nd 2009
From The Economist print edition

Selling schooling in a downturn

Report Digital



Can your parents still pay?

THE last time Britain was in recession, John, a lawyer, lost his job. He struggled to find new work, then set up on his own. The house was sold, and much of the proceeds spent on school fees. By 1998, after six rocky years for the family, the children had to be pulled out of school mid-year, even though the older had just one term to go before transferring to secondary. “The school was utterly unsympathetic,” says his wife. “Because we were in arrears, they wouldn’t let her finish the term, or go on a school trip we had already paid for.”

John’s story testifies to parents’ willingness to continue paying fees long past the point of prudence. Entering this recession, private schools expect more such tales of woe. But they also point out that most parents in the 1990s slogged on: the number of children in private education fell by only 11,500, or 2.4%.

This time, though, things may be different. Many parents simply have no slack in the budget left: MTM, an education consultancy, reckons 16% of families with at least one privately-educated child are already spending more than 40% of household income on fees. The standard fallbacks are looking increasingly unreliable: houses are hard to sell and harder to remortgage; grandparents are seeing their investment income plummet. Because fees have doubled in real terms since the last recession, to £10,000 a year on average for day schools, any money parents scrape together will be burned through much faster.

Fee increases may even insulate some schools from the downturn, by making them the preserve of the super-rich. Barney Northover of Veale Wasbrough, a legal firm with around 700 private schools among its clients, quotes one head teacher as saying, “All our parents could afford our fees ten times over.” Some schools even expect their cashflow to improve: he reports that more parents would like to pay for their children’s entire education in advance. “They get a discount, and it’s not as if there were good returns to be found anywhere else.”

At the less entrenched end of the market, some pain is inevitable. But rather than closing, schools, particularly small ones, are likely to join forces. Some may merge, others sell themselves to a chain, either private or charitable. Cognita, the biggest commercial-schools chain, already owns 45 schools in Britain and says its plans to grow by a dozen a year remain unchanged. The biggest impact is likely to be on preparatory schools, as parents decide to delay discretionary spending. Unless preps are near state grammar schools and hence have a secure niche drilling children for the 11-plus exams, they may seek to merge with secondary schools, which can then market an all-through education insulated from the vicissitudes of competitive entry at 11 or 13 years of age.

Parents would love to see those eye-watering fees come down, but that is not about to happen. The big names are even putting fees up—at Winchester, by £1,400 a year—to pay for bursaries for the non-super-rich, thus satisfying stringent new rules for educational charities. Elsewhere, capital projects will be delayed, but schools' biggest costs, salaries and pension contributions, tend to keep track with those on offer in the state sector, which have risen a lot since the 1990s. Private schools will point to other changes: league tables, which show their broadly better exam results; the decline of modern languages and sciences in state schools; the private sector's shift away from devalued GCSEs and A-levels to other exams that many universities find more useful. The hope is that these will prove enticing enough, whatever the cost.

The police

A new beat

Jan 22nd 2009
From The Economist print edition

Can Britain's next top policeman restore faith in the force?

AS COMPANIES tumble, London's biggest employer is holding interviews for a new chief executive. The Metropolitan Police, which employs some 50,000 officers and staff, needs a new boss following the unceremonious ousting of Sir Ian Blair in October. The decision belongs to Jacqui Smith, the home secretary; she will need the agreement of London's Tory mayor, Boris Johnson, who defenestrated Sir Ian in the first place. The Met's vast size, and its lead in fighting terrorism and formulating national policy, mean that its new boss will shape policing across the country. A decision is expected imminently.

The new commissioner will inherit a smouldering hot seat. Sir Ian's departure and a bizarre police raid on Parliament in November have stirred things up, but discontent with the men and women in blue is much more deeply rooted. Over the past 20 years, public confidence in the cops has ebbed. The first British Crime Survey, in 1982, found that 92% of respondents thought their local police were doing a fairly or very good job. This fell almost every year until 2003, the last time the question was asked, when it sank below 75%. A new survey suggests the beginnings of a recovery, but approval remains low: as a profession, policemen score closer to accountants, lawyers and other villains than to sainted public servants such as doctors and teachers. The nosedive in support is odd because it coincides with a period in which crime has fallen, albeit with a few exceptions such as teenage violence.

The police themselves are frustrated. "There's been a detachment from the people we're here to serve," says Paul McKeever, chairman of the Police Federation, a coppers' union. That detachment is felt by the public, too. In 1981 43% of people reported having contacted the police in the past year, usually just to ask directions in the street. By 2006 that had fallen to 27%, of whom most had reported a crime.

The estrangement is extraordinary, given that record numbers are on the payroll. England and Wales employ some 140,000 police, plus 16,000 lower-ranking community-support officers, making manpower a quarter higher than in the 1990s. The problem is their remoteness: according to King's College London, as little as 15% of police time is now spent on visible patrol.

The transformation of policemen from fearless crime fighters to clipboard carriers has two causes, both well-intentioned. One, designed to prevent corruption and expose racial biases, is obsessive record-keeping. Last year Sir Ronnie Flanagan, the chief inspector of constabulary, reported on a "staggering" increase in paperwork: one force used a 28-page booklet to record a missing person; another required 44 pages to report a traffic collision.

The other cause, intended to maintain standards, is a regime of performance targets set by civil servants. As in other public services, this has led to forces often "hitting the target but missing the point", as Ian Johnston, president of the Superintendents' Association, puts it. Take the child who made off with some charity sponsorship money, prompting police to record 542 crimes—one for each person who had made a donation. As such trivialities are observed, bigger fish have gone unfried.

Thankfully, change is afoot. Paperwork is being trimmed: since last month, police have been required to record only the ethnicity of those they stop on the street, ditching a mammoth form that took 25 minutes to complete. Forms for some minor crimes have been scrapped altogether. Mr Johnston reports that in pilot areas bobbies have been solving adolescent scuffles with an informal word, rather than rounds of interviews and reports. Central targets have also been ditched in favour of a single measure of public satisfaction. The Home Office will still set national "priorities", and forces may retain some internal targets. But officers are cautiously optimistic.

Quis custodiet ipsos custodes?

If the Home Office is letting go a little, who will keep the police in check? The Association of Chief Police

Officers would like good forces to be allowed simply to “plough their own furrows”. That would be dangerous: for all its faults, Whitehall’s oversight has helped to end the corruption that was endemic in some forces in the 1960s (the International Crime Victims Survey now ranks British police, judges and customs officers the least corrupt of 30 countries), and to stamp out racism in the ranks (non-white respondents now rate the police higher than whites do). But who should watch the watchmen?

One idea was to hand more control to voters, but that was dropped last month on a general worry about politicisation and a specific fear of far-right parties seizing control. The Tories would like to install elected police commissioners, but are squabbling internally about how much power to give them. Unless that goes ahead, it is likely that much control will remain in the Home Office. Bob Golding, a policeman turned academic, points out that the police will continue to be pushed around by a host of national monitoring agencies, from the Audit Commission to HM Inspector of Constabulary, a Home Office appointee who is about to be handed greater powers, subject to the passing of a new bill.

In London, there will be no lack of people keeping tabs on the new chief. As well as the Metropolitan Police Authority and the Home Office, he will face the mayor’s office and the 32 London councils. The new bill would allow him to appoint his own deputies, which may prevent the infighting that plagued Sir Ian. But until it is made clear to whom the police should answer, the next commissioner will have more than just criminals to worry about.

Regulating alternative medicine

But does it work?

Jan 22nd 2009
From The Economist print edition

Britain simultaneously licenses alternative medicine and outlaws it

Illustration by David Simonds



EVERY year Britons spend around £4.5 billion on treatments ranging from aromatherapy to yogic healing, with one in five visiting one of 150,000 alternative therapists. This huge business came under official regulation for the first time on January 19th, when the Complementary and Natural Healthcare Council (CNHC to its friends, Ofquack to critics), partly financed by the Department of Health and inspired by Prince Charles's Foundation for Integrated Health, opened its doors.

In a bold bid to impose order, the CNHC will register practitioners who sign a code of conduct, take out insurance and provide evidence of some training. It hopes to regulate a dozen therapies by the end of the year—including Reiki (a sort of energy channelling), homeopathy and aromatherapy—and have 10,000 therapists on its books. But registration is voluntary, and many alternative practitioners, despite the lure of official recognition, fear a state invasion of their turf.

Scientists and medics are uneasy too. Unlike the bodies that oversee doctors and nurses, the CNHC takes no interest in whether its practitioners' efforts actually work. This worries Edzard Ernst, a homeopath who claims to be the world's only professor of alternative medicine. He fears that a state register of therapists will be taken as official endorsement of their therapies.

Another arm of government may be sharper eyed. In the *Journal of the Scottish Law Society*, Douglas MacLaughlin, a Glaswegian lawyer, points out that consumer-protection laws new in 2008 specifically forbid false claims that a product can cure a disease. This could make life difficult for purveyors of alternative medicine, much of which does not work or has never been tested.

That one part of government licenses alternative medicine while another bans its main sales pitch reflects a wider chaos. Besides the CNHC and the Office of Fair Trading (the consumer-protection watchdog), the Medicines and Healthcare Regulatory Agency oversees homeopathy but no other alternative therapy. This agency, whose day job is to license conventional drugs, excuses homeopathy, unlike other treatments, from proving it is more effective than a placebo. With no medical regulator on the case, it has often been left to the Advertising Standards Authority to rule on whether alternative medicine does what it claims to.

David Colquhoun, a pharmacologist at University College London and a member of the CNHC, wants the National Institute for Health and Clinical Excellence, which rules on the cost-effectiveness of traditional therapies, to examine the evidence for complementary medicine. “The whole problem of regulating alternative medicine will remain impossibly chaotic until the government grasps the nettle of deciding what works and what doesn’t,” he says.

Bagehot

An unaffordable luxury

Jan 22nd 2009
From The Economist print edition

The trajectory of British foreign policy during the recession

Illustration by Steve O'Brien



AT FIRST, only two podiums were set up for the press conference at the impressively chaotic post-Gaza summit held, on January 18th, in a golf resort in Sharm el-Sheikh: one for Hosni Mubarak, Egypt's president and the host, and one for Nicolas Sarkozy. This did not please the British contingent, whose plane had already been forced to circle above the Sinai peninsula while the French president landed. Then, moments before the soundbites were to be uttered, a phalanx of panicky Egyptians dismantled the podiums and dragged in a dais, some carpets and a long table. Gordon Brown eventually squeezed in between José Luis Rodríguez Zapatero of Spain and Italy's Silvio Berlusconi.

It was a vignette that captured the current pitch of Britain's foreign policy. The country is still at the top table, but not at its centre; it has a role in fresh crises, but mainly, it seems, when the firing has ceased. The slippage is partly due to its prime minister, who lacks the dynamism of his predecessor, Tony Blair, and Mr Sarkozy. But it is a consequence also of Britain's economic recession.

Britain and Mr Brown have so far avoided two of the obvious risks and temptations for foreign policy during slumps: diversionary adventurism and protectionist isolationism. The impact of this downturn is quieter—a kind of quiescence. During the actual fighting in Gaza, for example, although Britain drafted the UN resolution of January 8th, Mr Brown mostly kept his head down. The same was true during last summer's war in Georgia.

There are some plausible excuses for this low profile. Mr Brown, say his aides, was intimately involved in the Gaza diplomacy, but in private and by telephone. There are hints that he sees Anglo-Franco-German unity as the best way to maximise British influence on some questions. Britain's relations with Russia were perhaps too poisonous for it to broker a peace in Georgia.

But there have been other indicators of a gentle slide from robustness towards humility. Last autumn Britain softened its view on the European Union's approach to Russia. It also revised its policy on Tibet, explicitly recognising China's sovereignty over the territory, in place of the arcane concept of "suzerainty". The Chinese were delighted. This is evidently regarded as a time for Britain to ingratiate itself with big, tricky countries, rather than to irk them. (There is an exception: David Miliband, the foreign secretary, has proved Britain's continuing ability to cause offence, if nothing else, in some parts of the world, by provoking outrage in India with some bald remarks about Kashmir.)

Two domestic shortages help to explain the new modesty. Attention is in short supply: Downing Street is now inevitably concentrating on the economy. Worries about how Mr Brown is perceived to be spending his time may also be involved: he does not want to be seen gallivanting around Arabia conspicuously while the pound plummets and banks totter.

The other shortage is of cash. The government struggled to put its money where Mr Blair's mouth was—to find the resources that the wars in Iraq and Afghanistan needed—even in the fat years. Now it will be harder still to maintain defence spending. That will be true in other countries, too; but few, besides America, have been as militarily active as Britain. Notwithstanding Mr Brown's quaint-sounding offer of British ships to help intercept weapons in the Red Sea and the Gulf of Aden, no other country's military ambition is likely to look so shrunken.

And there is another, related reason for the subtle diminution of Britain's foreign policy. The country's diplomatic clout over the past decade was due not only to Mr Blair's personal oomph. He and Mr Brown, then his chancellor, seemed to other leaders to have found the elixir of electoral victory, as well as of perpetual economic growth. Both bits of the magic have now worn off: as unemployment mounts, Labour is again far behind the Conservatives in the opinion polls. The whiff of forthcoming defeat may dissuade other leaders from embracing Mr Brown too tightly.

Among them, perhaps, Barack Obama. President Obama is expected in London for the G20 summit in April, to discuss the aspect of international relations in which Mr Brown hopes to lead: reform of the world's financial institutions and the global response to the credit crunch. But he may find Mr Obama—in any case not as obviously Anglophile as most of his recent predecessors—less keen to cultivate him than the prime minister hopes, and drawn to other European leaders who seem more active in world affairs. Britain's reluctance to send more troops to Afghanistan may also disappoint him. If Mr Obama keeps his distance, Britain's weight in the EU and elsewhere will be affected.

A period of repose

Diplomacy can be exhausting. Later on January 18th the summiteers reconvened in a chilly marquee at the Jerusalem residence of Israel's prime minister. Now their greatest yen seemed not to go first, but to go to sleep. Mr Berlusconi rambled; Angela Merkel bored; Mr Sarkozy overdid it. It was Mr Brown who struck the right tone—averring support for Israel before urging compromise.

The widespread view that Mr Brown's only real foreign-policy interests are economic is not absolutely fair. He genuinely cares about Israel—his father, as he recounted last year in a moving speech in that country's parliament, was chairman of the Church of Scotland's Israel committee—and his concern for civilian suffering, especially that of children, seems sincere. He also has a better feel for the nuances of diplomacy than is often credited, or than his occasional awkwardness and malapropisms suggest. He doubtless believes that, under his leadership, Britain can be a force for good; he probably does not see it as part of his prime-ministerial mission to preside over a diplomatic decline.

Nevertheless, assertive international engagement seems to be a luxury that the country cannot afford in the downturn. The parallel recession in Britain's foreign policy, however, may turn out to have a cost of its own.

Terrorism

The growing, and mysterious, irrelevance of al-Qaeda

Jan 22nd 2009
From The Economist print edition

Military setbacks and ideological disputes have put al-Qaeda on the defensive

Illustration by David Simonds



OSAMA BIN LADEN'S messages from the wilderness get little attention nowadays. Al-Qaeda has been unable to land a blow on Western soil since the 2005 London bombings. Its leaders lurk in Pakistan's tribal belt, hiding from regular lethal attacks by America's unmanned Predator aircraft. Their Pushtun hosts are tiring of their troublesome guests. Perhaps most damaging, former supporters publicly denounce its ideology.

The resultant bickering and low morale do not mean that al-Qaeda and its followers cannot still mount spectacular attacks. Western intelligence services are convinced the group tried to blow up several transatlantic airliners in 2006. It can still pose a menace in, say, parts of Asia. But for now, Mr bin Laden has to try to exploit the news, rather than to make it.

So it was with his last philippic, an audio recording issued on January 14th, in which he claimed that his *jihad* against America since 2001 had been responsible for bringing about the superpower's economic collapse. His followers would "continue *jihad* for another seven years, seven more after that, and even seven more after." The inauguration of Barack Obama, he said, changes nothing; democracy is a form of "polytheism". The new president is "like one who swallows a double-edged sword" and will be hurt however he moves. If he withdraws from his predecessor's wars, Mr Obama suffers military defeat; if he continues, he deepens the economic crisis.

Above all, Mr bin Laden sought to exploit Muslim outrage over Israel's war in Gaza. Forget about street protests, diplomatic mediation or treacherous Arab leaders, said Mr bin Laden; the only way to defeat Israel was through *jihad*. Jonathan Evans, the head of MI5, Britain's domestic intelligence service, is among those who worry that the war in Gaza will have radicalised more Muslims.

Yet Palestine is a problem as well as an opportunity for al-Qaeda. It wants to be linked with the cause that is dearest to Muslims' hearts, but it has little to offer. Others have fought harder against Israel, chiefly Hamas, the Palestinian branch of the Muslim Brotherhood, and Hizbullah, the Shia militia in Lebanon. But jihadists of al-Qaeda's sort regard the Muslim Brotherhood as, at best, deviant. By taking part in elections they place man's law above God's. And they see Shias as apostates.

Al-Qaeda's failure to fight for Palestine comes up repeatedly in jihadist internet forums. It also forms part of the latest ideological counter-attack against al-Qaeda by Sayyid Imam al-Sharif, one of its founders in 1998 and a leading jihadist ideologue under the pen-name "Dr Fadl". He has since fallen out with its leaders, particularly Ayman al-Zawahiri, who succeeded him as head of Egypt's Islamic Jihad group. Al-Qaeda, he now says, "did not offer Palestine anything except words".

Dr Fadl was arrested in Yemen in 2001 and extradited to Egypt. His first assault on al-Qaeda for its profligate killing of Muslims, at the end of 2007, prompted Mr Zawahiri to write a rebuttal of nearly 200 pages. The rejoinder to that, issued in November, was serialised in an Egyptian newspaper. His latest critique ranges from personal attacks on Mr Zawahiri to accusations that al-Qaeda has distorted Islamic law on *jihad* and inflicted a series of disasters on Muslims.

Dr Fadl accuses Mr Zawahiri of being an agent of the Sudanese intelligence services who agreed to carry out ten attacks in Egypt in the 1990s in exchange for $100,000. He denounces him as a liar and a coward who incites others to die in *jihad* while not taking part in the fighting. Egyptian prisons and graveyards were filled with jihadists, but Mr Zawahiri fled abroad, he says.

Al-Qaeda blames America for all the woes of the Muslim world. But Dr Fadl says the problem is Muslims' own failings. He accuses al-Qaeda of declaring entire populations, even in Muslim countries, to be apostates, and of establishing a "criminal doctrine" of wholesale slaughter. This defies traditional injunctions in Islamic law against indiscriminate killing. Even the killing of non-believers in war is restricted, he avers, pointing to the bans on killing women, boys, the demented and hired hands such as labourers and peasants.

The attacks on America in 2001, says Dr Fadl, prompted foreign invasions and the destruction of the "Islamic state" set up by the Taliban. It led to the death of more Muslims than have been killed in all of Israel's wars. "Every drop of blood that was shed or is being shed in Afghanistan and Iraq is the responsibility of bin Laden and Zawahiri and their followers," he writes. Their talk of Palestine is "just for propaganda"; they cannot find allies among Palestinians.

Do the ideological revisions of Dr Fadl, facilitated by the Egyptian security services, matter when the assault in Gaza may have won al-Qaeda new supporters? Some officials argue that the emotional fury will pass; they say Dr Fadl's first attack hurt al-Qaeda even though it followed Israel's equally brutal war in Lebanon in 2006. But pundits such as Bruce Hoffman, of Georgetown University in Washington, think the impact will be marginal. "Dr Fadl discomfits al-Qaeda," he says. "Young hotheads are not going to listen to some geriatric sitting in an Egyptian prison. But al-Qaeda worries he might have an impact on its finances."

Counter-terrorism officials say that al-Qaeda is short of money. Individual attacks may be quite cheap, but running an organisation—and supporting the families of members who are killed—is costly. Tellingly, Mr bin Laden appealed for money in his last message, arguing that Muslims had a duty to wage "financial *jihad*". What better way to raise funds than to evoke the unending agony of Palestine?

NATO

Who can unite the allies?

Jan 22nd 2009
From The Economist print edition

Contenders are lining up for the race to be NATO's new secretary-general

AP Jupiter Images



MacKay, Fogh Rasmussen and Sikorski

THE world's most successful military alliance is looking for a new boss. On January 26th, NATO ambassadors will start talking about who should replace Jaap de Hoop Scheffer as secretary-general when he steps down this summer. The decision could be made at the 60th-anniversary summit in April, though that may be too soon for America's new administration.

NATO congratulates itself on winning the cold war without firing a shot, and then reuniting Europe with its eastward expansion. Yet the mood is of trouble and uncertainty. NATO's hot war, in Afghanistan, is going badly and the alliance is at odds over further expansion. Relations with its neighbour in Brussels, the European Union, are paralysed even though many countries are members of both. Other issues on the new secretary-general's desk will be Europe's feeble spending on defence and the question of how much military planning is needed to cope with Russia's sabre-rattling.

Poland's foreign (and ex-defence) minister, Radek Sikorski, is an early front-runner. An Oxford-educated refugee from communism, he would symbolise the continent's unification, say his supporters. He runs Poland's newly emollient foreign policy fairly convincingly and knows Afghanistan from cold-war days. But west European countries with good ties to Russia, particularly Germany, worry that his appointment would irritate the Kremlin.

Another eastern possibility is Solomon Passy, the Trabant-driving former foreign minister of Bulgaria. He has already headed the Organisation for Security and Co-operation in Europe, a broad security forum that includes Russia. That could make him more acceptable to the Kremlin. But he may be too obscure: many allies want a secretary-general with political clout, "somebody whose phone calls will be answered when he calls European leaders", as a NATO insider puts it.

Clout is Anders Fogh Rasmussen's strong suit. As Danish prime minister since 2001, he sent his country's troops to serve alongside American ones in Iraq and Afghanistan. But Mr Fogh Rasmussen is thought to be more interested in becoming the EU's first permanent president, if that position ever materialises. Radical Islamists' ire over cartoons of the Prophet Muhammad in Danish newspapers might be another problem: a Danish connection might not help NATO to pacify the Taliban.

Two Canadian possibilities are Peter MacKay and John Manley, defence and former foreign ministers respectively. Canada has transformed its armed forces and fought hard in Afghanistan. But NATO may prefer somebody from an EU country to help overcome the friction between the two bodies. If so, that would rule out another possible European, Norway's foreign minister, Jonas Gahr Store.

One contender is Britain's soft-spoken former defence secretary, Des Browne. But Britain is detested by jihadists even more than Denmark. Mr Browne lost his cabinet seat last year, and a Briton, George Robertson, was secretary-general as recently as 2003. A French candidate might seal that country's re-entry into NATO's military structure, which will be confirmed at the April summit. But many allies will want to wait to see more evidence that France has really given up being the leader of NATO's awkward squad.

That role is passing to Germany, which places big restrictions on what its forces can do in Afghanistan, and has ties with Russia that irk former Soviet satellites. Some NATO insiders think the best way to stop Berlin from becoming the new Paris might be to appoint a senior German with solid pro-American credentials to NATO's top job—in effect, not Germany's man at NATO, but NATO's man for Germany.



Development

Fairly happy birthday

Jan 22nd 2009
From The Economist print edition

A paean of faint praise to the World Development Report

REMEMBER 1978? It has an oddly familiar feel. Economic growth was plummeting, and was about to fall further. After a daunting rise earlier in the decade, raw-material prices were falling. For most poor countries, it was a period of mounting frustration as one development nostrum after another—capital accumulation, infant-industry protection, input-output modelling—failed to live up to its promise. That was also the year the World Bank issued its first World Development Report (WDR). The aim, said Robert McNamara, then the bank's president, was to provide "a comprehensive assessment of the global development issues". Thirty reports later, the reissue of a single electronic version of all these flagship publications of the World Bank is a chance to assess fashions in development and ask what good they did.

The world may be awash in statistics about poverty and globalisation now, but when the WDR first appeared, reliable figures were much scarcer. The reports led the way to what may fairly be described as a revolution in documenting development.

The 1990 WDR, for example, introduced what has now become the universal yardstick for measuring absolute poverty: income of a dollar a day or less. This standard was embodied in the first millennium development goal (to halve the proportion of the world living below that level). The 1993 WDR introduced another measure that has become a basic tool, the DALY, or disability-adjusted life year. This enables health officials to compute the burden of disease associated with different conditions, from tuberculosis to migraine and cancer. That report is credited with persuading Bill Gates to make health one of three concerns for his foundation's programmes. But as Angus Deaton of Princeton University points out, these are advances in measurement, not intellectual breakthroughs. They have not changed anyone's mind about how to make countries richer.

Perhaps that was inevitable. Though Joseph Stiglitz, a former chief economist for the World Bank, says he wanted the WDR to raise hard questions—even ones the bank could not answer—in practice this rarely happened. As Shahid Yusuf shows in a new book*, the WDRs have mostly reflected conventional thinking. No wonder: as the WDRs became successful, more and more people in the bank sought to influence what they said.

This makes them histories in miniature of development. During the 1980s, the reports highlighted the shift away from earlier beliefs (the secret of growth is to raise investment as high as possible and pour it into industry) towards "structural adjustment" (reducing fiscal imbalances) and "getting the prices right". Then, in the 1990s, they changed again, this time in the direction of greater complexity. The secret of growth was then not just to strengthen the market but to cut the costs of doing business, to improve education and skills, to upgrade technology and, especially, to strengthen public institutions by reducing corruption and improving the rule of law.

As they changed, the WDRs gained in professionalism and expertise. The 1990 report on poverty, for example, saw the problem almost exclusively in terms of income. The 2000 WDR, also on poverty, talked about security and lack of accountability too: these are matters the poor themselves are no less concerned about.

But along the way, something got lost. The first WDR was 68 pages; the latest is 368 pages. As Mr Yusuf wistfully remarks, the slender first report won a worldwide readership but few people now read past the lengthy executive summaries.

Despite the bank's best efforts, economic growth remains a mystery: no one really knows why some countries sustain it over decades and others do not. Bill Easterly of New York University criticises the WDRs for not helping poor countries decide what to do when things are so uncertain. That may seem

harsh, given that the reports have contributed more than their fair share to the world's stock of knowledge. Thanks to them, economists now know much more about what does not work. But it is not so clear they understand any better what does.

---

* Development Economics through the decades. By Shahid Yusuf. The World Bank. (Members of *The Economist* staff edited the WDRs until 1993.)

Public health

So near, yet so far

Jan 22nd 2009 | NEW YORK
From The Economist print edition

Global health campaigners try again to eradicate polio

HUMANITY'S greatest accomplishment of the past five decades, declared Bill Gates this week, is the reduction in the number of deaths among young children by half, to 10m a year in 2007. The world's most successful capitalist heaped praise on the World Health Organisation (WHO), while unveiling an ambitious new global scheme to eradicate polio within a few years. For his part, the agency's top polio man, Bruce Aylward, described the fight against the disease in the language of markets: "Eradication is the venture capital of public health: the risks are huge but so too are the rewards."

The use of this sort of language captures a change in public health in the past decade. The Gates Foundation, with its pots of money and businesslike approach (see article), has transformed the bureaucratic and demoralised world of public health. It has helped revive ailing campaigns, including the fight against polio. This will now get a fresh $600m-plus, from British and German taxpayers, from the Rotary Club International, as well as from the Gates Foundation ($255m).

The decline from 350,000 new cases in 1988 (when the goal of rapid polio eradication was first declared) to 2,000 cases now (chiefly in Nigeria, India, Pakistan and Afghanistan) looks like a near victory. But the final stretch is the hardest. Only one in 200 cases is readily susceptible to early detection (as opposed to most victims of smallpox, already eradicated). Polio is also far more infectious.

Other snags are that the usual vaccine has not worked well in densely populated, disease-ridden central India. Researchers are now trying to find a vaccine that fits those conditions better. Neal Halsey, of Johns Hopkins University, says the "live" vaccines used commonly today must be backed up with further doses of "inactivated" vaccines. These need to become cheaper.

The fighting in Afghanistan and Pakistan has hampered vaccination programmes there. So have rumours among Muslims in northern Nigeria that the vaccination programme was in fact a conspiracy to sterilise children. That allowed the polio virus to strengthen and spread. The Nigerian strain may have now reached a dozen other countries.

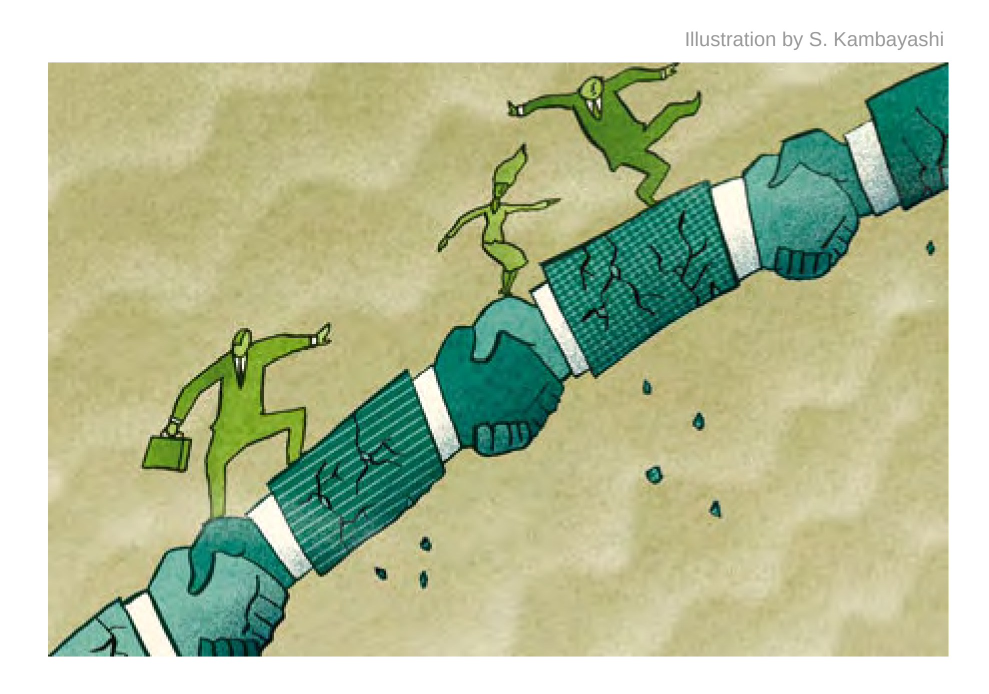
The final push towards eradication will certainly be costly, though several recent studies suggest that it is cheaper to spend money on a big eradication effort now than to pay the price later for sustained vigilance and health costs. The prospect of a global resurgence is concentrating minds. That is why, despite the daunting challenges and potential donor fatigue, the world may end up making a go of eradication this time.

Greed—and fear

Jan 22nd 2009
From The Economist print edition

The golden age of finance collapsed under its own contradictions. Edward Carr (interviewed here) asks why it went wrong and what to do next

Illustration by S. Kambayashi



THE monument to Soviet central planning was supposed to have been a heap of surplus left boots without any right ones to match them. The great bull market of the past quarter century is commemorated by millions of empty houses without anyone to buy them. Gosplan drafted workers into grim factories even if their talents would have been better suited elsewhere. Finance beguiled the bright and ambitious and put them to work in the trading rooms of Wall Street and the City of London. Much of their effort was wasted. You can only guess at what else they might have achieved.

When the financial system fails, everyone suffers. Over the past 22 months the shock has spread from American housing, sector by sector, economy by economy. Some markets have seized up; others are being pounded by volatility. Everywhere good businesses are going bankrupt and jobs are being destroyed. For the first time since 1991 global average income per head is falling. Even as growth in emerging markets has come to a halt, the rich economies look set to shrink. Alan Greenspan, who as chairman of America's Federal Reserve oversaw the boom, calls the collapse "a once-in-a-half-century, probably once-in-a-century type of event". Financial markets promised prosperity; instead they have brought hardship.

Financial services are in ruins. Perhaps half of all hedge funds will go out of business. Without government aid, so would many banks. Britain has suffered its first bank-run since Disraeli was prime minister in the 1870s. America has stumbled from one rescue to the next. The Wall Street grandees have been humbled. Hundreds of thousands of people in financial services will lose their jobs; many millions of their clients have lost their savings.

For a quarter of a century finance basked in a golden age. Financial globalisation spread capital more widely, markets evolved, businesses were able to finance new ventures and ordinary people had unprecedented access to borrowing and foreign exchange. Modern finance improved countless lives.

But more recently something went awry. Through insurance and saving, financial services are supposed to offer shelter from life's reverses. Instead, financiers grew rich even as their industry put everyone's prosperity in danger. Financial services are supposed to bring together borrowers and savers. But as lending markets have retreated, borrowers have been stranded without credit and savers have seen their pensions and investments melt away. Financial markets are supposed to be a machine for amassing

capital and determining who gets to use it and for what. How could they have been so wrong?

Finance is increasingly fragile. Barry Eichengreen of the University of California at Berkeley and Michael Bordo of Rutgers University identify 139 financial crises between 1973 and 1997 (of which 44 took place in high-income countries), compared with a total of only 38 between 1945 and 1971. Crises are twice as common as they were before 1914, the authors conclude.

The paradox is that financial markets can function again only if this lesson is partly forgotten. Financial transactions are a series of promises. You hand your money to a bank, which promises to pay it back when you ask; you invest in a company, which promises you a share of its future profits. Money itself is just a collective agreement that a piece of paper can always be exchanged for goods or services.

Imagine, for a second, how finance began, with small loans within families and between trusted friends. As the circle of lenders and borrowers grew, financial transactions were able to muster larger sums and to spread risk, even as promises became harder to enforce. Paul Seabright, an economist at the University of Toulouse in France, observes that trust in a modern economy has evolved to the miraculous point where people give complete strangers sums of money they would not dream of entrusting to their next-door neighbours. From that a further miracle follows, for trust is what raises the billions of dollars that fund modern industry.

Trust's slow accumulation pushes financial markets forward; its shattering betrayal batters them back. Sometimes this is through bad faith, as when Bernie Madoff, a grand fund manager, allegedly made his investors $50 billion poorer, or mortgage-sellers tempted naive borrowers. But promises made in good faith can be broken too. Indeed, honest failure is even more corrosive of trust than outright criminality. Everyone understands that now.

New order

The failure of finance will affect ideology, too. Many people find capitalism's central planner hard to put up with at the best of times. Free markets shun seemingly worthy causes, whereas the frivolous or apparently undeserving are rewarded. Look at the financial-services industry itself. In America middle-class pay has stalled in recent years but financiers have figured prominently among the tiny number of people who have captured much of the extra income. For as long as the world economy was growing fast, financial markets commanded grudging allegiance. Yet the same financiers who preached the necessity of free markets on the way up have since depended on taxpayers to save their industry at a cost of trillions of dollars.

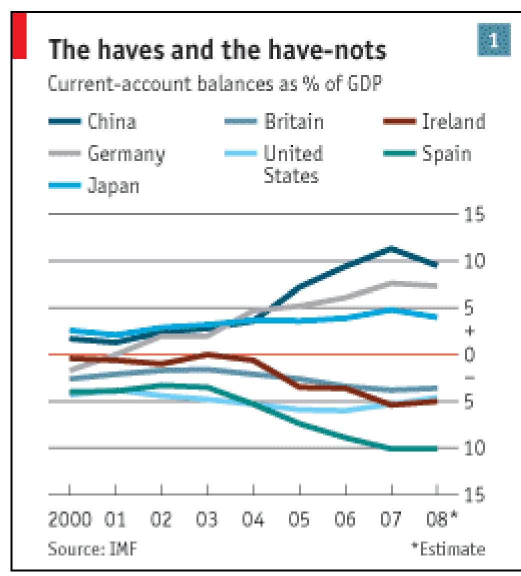
Financiers will find the arguments for free markets harder to make now that they have lost the benefit of the doubt. Charles Kindleberger's classic study, "Manias, Panics and Crashes: A History of Financial Crises", updated by Robert Aliber in 2005, suggests that financial instability feeds on itself. Japanese savings fled their own bust and sloshed first into the Nordic countries and then into Asia, which suffered contagion in 1997.

Some see today's disaster as a result of that Asian crash. Asian nations—especially China—have been determined to be part of global capital markets but not to run current-account deficits which would leave them vulnerable to sudden currency outflows. So they have been happy to see their money go abroad. In the phrase of Martin Wolf, an economic columnist at the *Financial Times*, they "smoke but do not inhale".

In 2006 America's current-account deficit peaked at 6% of its GDP (see chart 1). Between 2000 and 2008 the country received over $5.7 trillion from abroad to invest, equivalent to over 40% of its 2007 GDP. Over the same period Britain and Ireland absorbed around a fifth of their 2007 GDPs and Spain a vast 50%. The financial system had the job of recycling the money to borrowers. Inevitably, credit became cheaper and savings declined. In America savings fell from around 10% of disposable income in the 1970s to 1% after 2005.

Not everyone agrees about the cause of this torrent of foreign capital. Although some blame Asian saving, others point to Western extravagance. But there is little doubt about the consequences. All four of the debtor countries in the chart

enjoyed housing booms. Jeffry Frieden, a political economist at Harvard University, says about three-quarters of credit booms financed from abroad end up in crashes.



And yet financial services were not so much a victim of the inflows of foreign capital as an eager accomplice. The question is why financial systems are so liable to turn foreign credit into ruinous busts. In particular, why did America, home to the world's most advanced financial system, turn foreign credit into the world's most serious post-war bust?

The suspicion is that American know-how and talent made the disaster worse. Of all the financial instruments to have failed, newfangled collateralised-debt obligations (CDOs) have turned out to be among the most devastating. One way of thinking about CDOs, says Raghuram Rajan, a professor at the University of Chicago, is as a mechanism for converting mortgage securities and corporate bonds from huge, illiquid assets owned by local investors into liquid financial instruments that could be flogged across the world. Philip Lane, of Trinity College Dublin, thinks that sophisticated American financial services combined dangerously with relatively unsophisticated financial services elsewhere.

Never again, etc

If the price of sophistication is instability, something is wrong. You might conclude that the thing to do is to shackle finance as it was shackled in the 1950s and 60s. If ever there were a moment for this, it would be now. It takes a big upheaval to open the way for radical reform. The structure of financial regulation in America still bears the mark of ideas forged in the Depression.

Reform is certainly needed, yet, for all the excesses and instability of finance, a complete clampdown would be a mistake. For one thing, remember the remarkable prosperity of the past 25 years. Finance deserves some of the credit for that. Note, too, that finance has always been plagued by crises, whether the system is open or closed, simple or sophisticated. Attempts to regulate finance to make it safe often lead to dangerous distortions as clever financiers work around the rules. If there were a simple way to prevent crises altogether, it would already be the foundation stone of financial regulation.

In fact, the aim should be neither to banish finance nor to punish it, but to create a system that supports economic growth through the best mix of state-imposed stability and private initiative. Modern finance is flawed, unstable and prone to excess. But think of those boots and those wasted lives: planned markets are flawed, unstable and excessive too.

Wild-animal spirits

Jan 22nd 2009
From The Economist print edition

Why is finance so unstable?

Illustration by S. Kambayashi



WHEN people look back on a bubble, they tend to blame the mess on crookery, greed and the collective insanity of others. What else but madness could explain all those overpriced Dutch tulips? With hindsight, today's mortgage disaster seems ridiculously simple. Wasn't it the fault of barely legal mortgage underwriting, overpaid investment bankers and the intoxication of easy credit? Yet there is an element of the madhouse in that explanation too. Cupidity, fraud and delusion were obviously part of the great bust. But if they are the chief causes of bubbles—which have repeatedly plagued Western finance since its origins in the Italian Renaissance—you have to suppose that civilisation is beset by naivety and manic depression.

In fact, observes Abhijit Banerjee, an economist at the Massachusetts Institute of Technology, a little irrationality goes a long way. When reasonable, self-interested people trade with each other, optimism tends to breed optimism—until it subsides into corrosive pessimism. In the words of Willem Buiter, of the London School of Economics, "finance is a scary, inherently unstable, essential activity."

Financial services are different from other industries, if only because so much of the business is writing bets. One side pays the other for a claim that comes good if, say, oil prices fall, or a company defaults on its bonds, or householders make their mortgage payments on time. When people talk about losses in finance, they are often thinking about only one side of these contracts. In fact, for every loser on a credit-default swap, for example, there is a corresponding gainer. These are bets, remember: if the punters are down, the bookies are up by the same amount. In the jargon, the claims "net to zero".

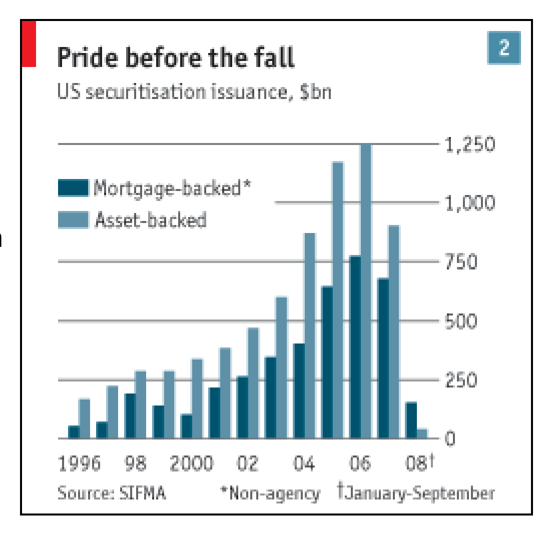
That sounds safe enough. Yet the winners and losers behave differently. The winners' extra spending may not offset the losers' retrenchment. And the losers may not be able to afford to pay out, either because they do not have the money—they are insolvent—or because they cannot easily raise the money—they are illiquid. This "counterparty risk", which grows with the volume of bets, has been the outstanding feature of this crisis. American International Group (AIG), once the world's biggest insurer, was bailed out by the American government when it became clear that it would not be able to honour its vast one-way bets on financial stability. Had AIG failed, the banks on the other side would have been in trouble. Although the market netted to zero, it was poised for disaster.

Infectious optimists

In a boom there is every chance that the betting will get out of hand. Expansion in most businesses is held in check by the need to build assembly lines, rent retail space or hire workers. All that takes time and money. By contrast, financial contracts can be written almost instantaneously and without limit.

Whenever issuers compete for market share or buyers pile in because they are afraid of missing the boat, a boom may be in the making. Investors herd together in this way because, as John Maynard Keynes argued, they do not have a sure grasp of the future. Faced with uncertainty, they resort to whatever conventions they can find to cling to, from popular wisdom to new theories. In a boom, overconfident investors take on bets that they later find themselves unable to discharge.

Conventions are one reason why the appetite to buy financial assets tends to feed on itself (see chart 2). In textbook markets for goods, price increases lead to a fall in demand and to substitution. By contrast, rising asset prices tend to be seen, within limits, as a cause to buy. People take rising share prices as a sign of confidence and a reason to put money into their retirement accounts or mutual funds. More recently, falling prices have been taken as a signal to flee, even though shares are much cheaper than they were not so long ago.



Asset prices pull themselves up by their own bootstraps. As houses become more valuable, house owners feel richer. If they then spend more, companies make more money, which in turn increases the value of shares and bonds. Profitable companies invest and create jobs. As the economy thrives, there are fewer defaults. Lenders are therefore willing to lend more on easier terms. This extra credit makes asset markets liquid: if ever you need to sell something, there always seems to be a ready buyer. Ample credit also tends to feed into spending and asset prices. That makes people feel richer. And so it goes on.

For as long as people are optimistic, the creation of credit is hard to restrain. Although banks are usually happy to join in, they do not have to be involved, at least for a while. In the boom in Kuwait between 1977 and 1982, people started to use post-dated cheques to pay for shares and property. According to Kindleberger, the value of these circulating IOUs peaked at some $100 billion, a far larger sum than was kept on deposit in the banks.

Similarly, when the economy does well, borrowers want to take on more debt. Not only are managers ambitious to expand, but shareholders tend to encourage them. That is partly because in a boom they think it is a low-risk way to increase the return on equity. It is also because the burden of larger interest payments leaves managers with less scope to fritter away cash on pet projects that may not benefit their shareholders.

Things that go pop

Manifestly, this virtuous circle does not operate unchecked. Potential bubbles often collapse early and harmlessly because fundamental forces are pulling in the other direction. Investors, torn between being late and being wrong, are restrained by rules of thumb, such as historical analogies and price-earnings ratios for shares. Their optimism is continually buffeted by scares and speculators who test whether a rising market is robust. The authorities carry out their original duty, to watch over the banking system, and they can use their newer powers by raising interest rates to damp down spending and borrowing.

However, bubbles sometimes get out of hand, and if they do, at some point they will stop inflating and start deflating. The cause can be small or large. A failed airline buy-out finished the debt-fuelled boom at the end of the 1980s; the entire housing market went wrong in 2007.

The more efficient the financial system, the faster fear will spread. As asset prices fall, people spend less and investors foreshadow lower profits and higher defaults by running from corporate bonds and shares. When investors lose confidence that other people will honour the promises that underpin financial assets, they retreat to government bonds, cash or gold, which are more dependable. Liquidity and credit suddenly become scarce and a devastating, value-destroying uncertainty takes hold. In 2007 Dick Fuld, the former head of Lehman Brothers, observed that whereas credit grows arithmetically, it shrinks geometrically. Much to his cost, he was later proved right.

Investors take all sorts of precautions to ensure that the people they deal with will honour their promises. They demand regulation and accurate accounts that price assets at market values; they want loans to be backed by collateral and covenants; they ask specialist agencies to rate borrowers'

creditworthiness; and so on. Such safeguards, essential as they are in policing individual lenders, tend to feed greed in greedy times and fear in fearful ones.

Chart 3 shows how lenders to banks registered alarm after Lehman collapsed in September last year. So worried were they about the risk of being wiped out in a bankruptcy or a state rescue that they suddenly started to demand that banks hold much more capital against their assets. For decades this ratio had been stable, below 10% of book assets, though it was over 50% in the 1840s, when banks were apt to fail more often.



Nobody can be sure how much capital shareholders now want banks to hold, but Alan Greenspan, a consultant these days, thinks the figure could have grown to 15% of their assets. If so, the banks will have to raise money and sell loans and securities even as politicians are asking them to lend more. Investors' desire for extra protection has made the contraction of credit worse.

The same thing happened with collateral. As the number of defaults falls in the boom, borrowers' credit ratings improve, assets are highly valued and lenders accept a broader range of them. In the bust many borrowers have had to find more collateral to offset falling asset prices. Some borrowers may have had to post cash or some other liquid asset. Precisely when markets have turned down, forced asset sales have weakened them further. Borrowing has become harder and more expensive.

In the booming American housing market mortgage originators were happy to accept no security at all, lending 100% of the value of the house—partly because they thought house prices would continue to rise, and partly because they assumed the market would be liquid enough for them to palm the mortgages off on other investors. As it happened, the mortgage originators were wrong and the loans that were stuck on their books helped destroy their businesses.

Just say no

Some would seek to limit the ebb and flow of confidence with early warnings, as if financial busts were a hurricane or an outbreak of plague. Gordon Brown, Britain's prime minister, would like to see the IMF cast in that role.

History suggests that such schemes do not work. People enjoy booms. Walter Bagehot, an editor of *The Economist* in the 19th century, observed that "all people are most credulous when they are most happy." Whatever Mr Brown says now, politicians like booms too. As chancellor of the exchequer, if the IMF dared criticise the British economy he used to be dismissive.

Seers like Henry Kaufman, a Wall Street veteran, and Nouriel Roubini, of the NYU Stern School of Business in Manhattan, pointed to the risks of a disaster, but were largely ignored. When Paul Warburg, a renowned banker, spoke about a possible Wall Street collapse in 1929, he was accused of "sandbagging American prosperity". J.K. Galbraith, who recounts the story in "A Short History of Financial Euphoria", detects a whiff of anti-Semitism in Warburg's treatment.

If it is hard to stop booms once they are in full swing, it is no easier to prevent them from starting in the first place. Hyman Minksy, an unconventional economist who made it his life's work to study crises, was convinced that they arose spontaneously. Financial stability itself creates confidence and risk-taking, eventually leading to recklessness and instability. After the bust, stability will return and the cycle will begin again. Similarly, David Roche and Bob McKee, of Independent Strategy, an investment consultancy, among others, think credit started flowing more easily in the 1980s because the rich economies conquered inflation and the large emerging markets embraced globalisation.

Relax and enjoy it

Some booms started with liberalisation. Japan created a huge share and property bubble in the 1980s by

relaxing its strict banking regulation. The banks fell over each other to lend money as they jostled for market share. Extra credit found its way into stock and property prices. Kindleberger identified a similar pattern in Latin America and again in Poland and in parts of the former Soviet Union. Liberalisation brings many advantages, but unless it is carefully managed it can lead to trouble.

Some booms started with technological innovation. Carlota Perez, a Venezuelan economist, thinks that each new industrial technology favours its own sort of financing. Local banks grew up to raise capital for the small companies created in Britain's industrial revolution; joint-stock companies thrived when businessmen needed to finance the railways in the 19th century; industrial banks backed new continental European industries; consumer finance helped Americans buy cars and fridges in the early 20th century. Ms Perez links each financial innovation to its own booms and busts.

That seems deterministic. But the internet revolution really did spill over into the rest of business and finance. Paul Krugman, the most recent Nobel laureate for economics, puts it with characteristic acerbity: the huge, strait-laced, bureaucratic corporations that ruled the roost before the dotcoms were, he says, like "socialism without the justice". By contrast, internet business was full of optimism. And in finance, optimism is everything.

Powerful new computers also created a platform for a new sort of mathematical finance. In the hands of "quants"—the mathematicians and physicists expert in the arcana of quantitative analysis—this proved immensely versatile. Unfortunately, it also led financial services astray.

In Plato's cave

Jan 22nd 2009
From The Economist print edition

Mathematical models are a powerful way of predicting financial markets. But they are fallible

Illustration by S. Kambayashi



ROBERT RUBIN was Bill Clinton's treasury secretary. He has worked at the top of Goldman Sachs and Citigroup. But he made arguably the single most influential decision of his long career in 1983, when as head of risk arbitrage at Goldman he went to the MIT Sloan School of Management in Cambridge, Massachusetts, to hire an economist called Fischer Black.

A decade earlier Myron Scholes, Robert Merton and Black had explained how to use share prices to calculate the value of derivatives. The Black-Scholes options-pricing model was more than a piece of geeky mathematics. It was a manifesto, part of a revolution that put an end to the anti-intellectualism of American finance and transformed financial markets from bull rings into today's quantitative powerhouses. Yet, in a roundabout way, Black's approach also led to some of the late boom's most disastrous lapses.

Derivatives markets are not new, nor are they an exclusively Western phenomenon. Mr Merton has described how Osaka's Dojima rice market offered forward contracts in the 17th century and organised futures trading by the 18th century. However, the growth of derivatives in the 36 years since Black's formula was published has taken them from the periphery of financial services to the core.

In "The Partnership", a history of Goldman Sachs, Charles Ellis records how the derivatives markets took off. The International Monetary Market opened in 1972; Congress allowed trade in commodity options in 1976; S&P 500 futures launched in 1982, and options on those futures a year later. The Chicago Board Options Exchange traded 911 contracts on April 26th 1973, its first day (and only one month before Black-Scholes appeared in print). In 2007 the CBOE's volume of contracts reached almost 1 trillion.

Trading has exploded partly because derivatives are useful. After America came off the gold standard in 1971, businesses wanted a way of protecting themselves against the movements in exchange rates, just as they sought protection against swings in interest rates after Paul Volcker, Mr Greenspan's predecessor as chairman of the Fed, tackled inflation in the 1980s. Equity options enabled investors to lay off general risk so that they could concentrate on the specific types of corporate risk they wanted to trade.

The other force behind the explosion in derivatives trading was the combination of mathematics and computing. Before Black-Scholes, option prices had been little more than educated guesses. The new model showed how to work out an option price from the known price-behaviour of a share and a bond. It is as if you had a formula for working out the price of a fruit salad from the prices of the apples and oranges that went into it, explains Emanuel Derman, a physicist who later took Black's job at Goldman. Confidence in pricing gave buyers and sellers the courage to pile into derivatives. The better that real prices correlate with the unknown option price, the more confidently you can take on any level of risk. "In a thirsty world filled with hydrogen and oxygen," Mr Derman has written, "someone had finally

worked out how to synthesise H_2O."

Poetry in Brownian motion

Black-Scholes is just a model, not a complete description of the world. Every model makes simplifications, but some of the simplifications in Black-Scholes looked as if they would matter. For instance, the maths it uses to describe how share prices move comes from the equations in physics that describe the diffusion of heat. The idea is that share prices follow some gentle random walk away from an equilibrium, rather like motes of dust jiggling around in Brownian motion. In fact, share-price movements are more violent than that.

Over the years the "quants" have found ways to cope with this—better ways to deal with, as it were, quirks in the prices of fruit and fruit salad. For a start, you can concentrate on the short-run volatility of prices, which in some ways tends to behave more like the Brownian motion that Black imagined. The quants can introduce sudden jumps or tweak their models to match actual share-price movements more closely. Mr Derman, who is now a professor at New York's Columbia University and a partner at Prisma Capital Partners, a fund of hedge funds, did some of his best-known work modelling what is called the "volatility smile"—an anomaly in options markets that first appeared after the 1987 stockmarket crash when investors would pay extra for protection against another imminent fall in share prices.

The fixes can make models complex and unwieldy, confusing traders or deterring them from taking up new ideas. There is a constant danger that behaviour in the market changes, as it did after the 1987 crash, or that liquidity suddenly dries up, as it has done in this crisis. But the quants are usually pragmatic enough to cope. They are not seeking truth or elegance, just a way of capturing the behaviour of a market and of linking an unobservable or illiquid price to prices in traded markets. The limit to the quants' tinkering has been not mathematics but the speed, power and cost of computers. Nobody has any use for a model which takes so long to compute that the markets leave it behind.

The idea behind quantitative finance is to manage risk. You make money by taking known risks and hedging the rest. And in this crash foreign-exchange, interest-rate and equity derivatives models have so far behaved roughly as they should.

A muddle of mortgages

Yet the idea behind modelling got garbled when pools of mortgages were bundled up into collateralised-debt obligations (CDOs). The principle is simple enough. Imagine a waterfall of mortgage payments: the AAA investors at the top catch their share, the next in line take their share from what remains, and so on. At the bottom are the "equity investors" who get nothing if people default on their mortgage payments and the money runs out.

Despite the theory, CDOs were hopeless, at least with hindsight (doesn't that phrase come easily?). The cash flowing from mortgage payments into a single CDO had to filter up through several layers. Assets were bundled into a pool, securitised, stuffed into a CDO, bits of that plugged into the next CDO and so on and on. Each source of a CDO had interminable pages of its own documentation and conditions, and a typical CDO might receive income from several hundred sources. It was a lawyer's paradise.

This baffling complexity could hardly be more different from an equity or an interest rate. It made CDOs impossible to model in anything but the most rudimentary way—all the more so because each one contained a unique combination of underlying assets. Each CDO would be sold on the basis of its own scenario, using central assumptions about the future of interest rates and defaults to "demonstrate" the payouts over, say, the next 30 years. This central scenario would then be "stress-tested" to show that the CDO was robust—though oddly the tests did not include a 20% fall in house prices.

This was modelling at its most feeble. Derivatives model an unknown price from today's known market prices. By contrast, modelling from history is dangerous. There was no guarantee that the future would be like the past, if only because the American housing market had never before been buoyed up by a frenzy of CDOs. In any case, there are not enough past housing data to form a rich statistical picture of the market—especially if you decide not to include the 1930s nationwide fall in house prices in your sample.

Illustration by S. Kambayashi



Neither could the models take account of falling mortgage-underwriting standards. Mr Rajan of the University of Chicago says academic research suggests mortgage originators, keen to automate their procedures, stopped giving potential borrowers lengthy interviews because they could not easily quantify the firmness of someone's handshake or the fixity of their gaze. Such things turned out to be better predictors of default than credit scores or loan-to-value ratios, but the investors at the end of a long chain of securities could not monitor lending decisions.

The issuers of CDOs asked rating agencies to assess their quality. Although the agencies insist that they did a thorough job, a senior quant at a large bank says that the agencies' models were even less sophisticated than the issuers'. For instance, a BBB tranche in a CDO might pay out in full if the defaults remained below 6%, and not at all once they went above 6.5%. That is an all-or-nothing sort of return, quite different from a BBB corporate bond, say. And yet, because both shared the same BBB rating, they would be modelled in the same way.

Issuers like to have an edge over the rating agencies. By paying one for rating the CDOs, some may have laid themselves open to a conflict of interest. With help from companies like Codefarm, an outfit from Brighton in Britain that knew the agencies' models for corporate CDOs, issuers could build securities with any risk profile they chose, including those made up from lower-quality ingredients that would nevertheless win AAA ratings. Codefarm has recently applied for administration.

There is a saying on Wall Street that the test of a product is whether clients will buy it. Would they have bought into CDOs had it not been for the dazzling performance of the quants in foreign-exchange, interest-rate and equity derivatives? There is every sign that the issuing banks believed their own sales patter. The banks so liked CDOs that they held on to a lot of their own issues, even when the idea behind the business had been to sell them on. They also lent buyers much of the money to bid for CDOs, certain that the securities were a sound investment. With CDOs in deep trouble, the lenders are now suffering.

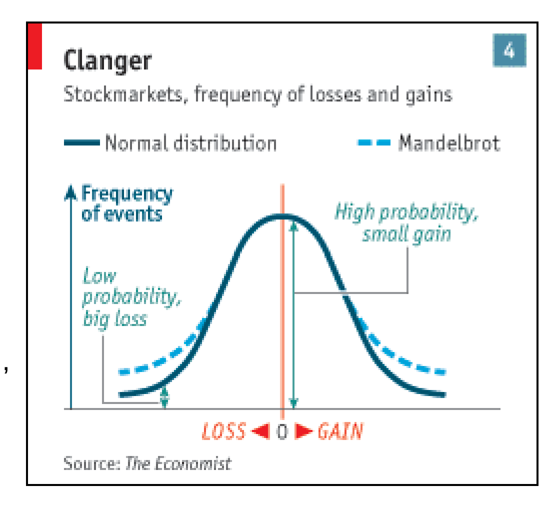
Modern finance is supposed to be all about measuring risks, yet corporate and mortgage-backed CDOs were a leap in the dark. According to Mr Derman, with Black-Scholes "you know what you are assuming when you use the model, and you know exactly what has been swept out of view, and hence you can think clearly about what you may have overlooked." By contrast, with CDOs "you don't quite know what you are ignoring, so you don't know how to adjust for its inadequacies."

Now that the world has moved far beyond any of the scenarios that the CDO issuers modelled, investors' quantitative grasp of the payouts has fizzled into blank uncertainty. That makes it hard to put any value on them, driving away possible buyers. The trillion-dollar bet on mortgages has gone disastrously wrong. The hope is that the trillion-dollar bet on companies does not end up that way too.

Almost as damaging is the hash that banks have made of "value-at-risk" (VAR) calculations, a measure of the potential losses of a portfolio. This is supposed to show whether banks and other

financial outfits are being safely run. Regulators use VAR calculations to work out how much capital banks need to put aside for a rainy day. But the calculations are flawed.

The mistake was to turn a blind eye to what is known as “tail risk”. Think of the banks’ range of possible daily losses and gains as a distribution. Most of the time you gain a little or lose a little. Occasionally you gain or lose a lot. Very rarely you win or lose a fortune. If you plot these daily movements on a graph, you get the familiar bell-shaped curve of a normal distribution (see chart 4). Typically, a VAR calculation cuts the line at, say, 98% or 99%, and takes that as its measure of extreme losses.



Tail spin

However, although the normal distribution closely matches the real world in the middle of the curve, where most of the gains or losses lie, it does not work well at the extreme edges, or “tails”. In markets extreme events are surprisingly common—their tails are “fat”. Benoît Mandelbrot, the mathematician who invented fractal theory, calculated that if the Dow Jones Industrial Average followed a normal distribution, it should have moved by more than 3.4% on 58 days between 1916 and 2003; in fact it did so 1,001 times. It should have moved by more than 4.5% on six days; it did so on 366. It should have moved by more than 7% only once in every 300,000 years; in the 20th century it did so 48 times.

In Mr Mandelbrot’s terms the market should have been “mildly” unstable. Instead it was “wildly” unstable. Financial markets are plagued not by “black swans”—seemingly inconceivable events that come up very occasionally—but by vicious snow-white swans that come along a lot more often than expected.

This puts VAR in a quandary. On the one hand, you cannot observe the tails of the VAR curve by studying extreme events, because extreme events are rare by definition. On the other you cannot deduce very much about the frequency of rare extreme events from the shape of the curve in the middle. Mathematically, the two are almost decoupled.

The drawback of failing to measure the tail beyond 99% is that it could leave out some reasonably common but devastating losses. VAR, in other words, is good at predicting small day-to-day losses in the heart of the distribution, but hopeless at predicting severe losses that are much rarer—arguably those that should worry you most.

When David Viniar, chief financial officer of Goldman Sachs, told the *Financial Times* in 2007 that the bank had seen “25-standard-deviation moves several days in a row”, he was saying that the markets were at the extreme tail of their distribution. The centre of their models did not begin to predict that the tails would move so violently. He meant to show how unstable the markets were. But he also showed how wrong the models were.

Modern finance may well be making the tails fatter, says Daron Acemoglu, an economist at MIT. When you trade away all sorts of specific risk, in foreign exchange, interest rates and so forth, you make your portfolio seem safer. But you are in fact swapping everyday risk for the exceptional risk that the worst will happen and your insurer will fail—as AIG did. Even as the predictable centre of the distribution appears less risky, the unobserved tail risk has grown. Your traders and managers will look as if they are earning good returns on lower risk when part of the true risk is hidden. They will want to be paid for their skill when in fact their risk-weighted returns may have fallen.

Edmund Phelps, who won the Nobel prize for economics in 2006, is highly critical of today’s financial services. “Risk-assessment and risk-management models were never well founded,” he says. “There was a mystique to the idea that market participants knew the price to put on this or that risk. But it is impossible to imagine that such a complex system could be understood in such detail and with such amazing correctness...the requirements for information...have gone beyond our abilities to gather it.”

Every trading strategy draws upon a model, even if it is not expressed in mathematical symbols. But Mr Phelps believes that mathematics can take you only so far. There is a big role for judgment and intuition, things that managers are supposed to provide. Why have they failed?

When markets turn

Jan 22nd 2009
From The Economist print edition

A parable of how modern finance can go wrong

GEORGE SOROS, one of the original hedge-fund managers, believes that every boom in the making is tested. Often the potential bubble succumbs and is forgotten. If it survives, the market's misplaced faith is redoubled. That, Mr Soros says, is when things become dangerous.

The test for the credit boom was Long-Term Capital Management (LTCM), a super-brainy hedge fund created by John Meriwether and his team from Salomon Brothers, along with Robert Merton and Myron Scholes, the pair of Nobel laureates who had worked with Fischer Black on options pricing. The markets should have learnt from LTCM's collapse, but they were too busy making money.

LTCM's strategy was to scour world markets for pairs of assets with prices that appeared to be out of line with each other. For instance, at Salomon Mr Meriwether's team had spotted that the 29-year Treasury bond was surprisingly cheap compared with the 30-year Treasury bond. If you think about it, the 30-year is just months from becoming a 29-year Treasury. It was dearer because a lot of people wanted it in their portfolios, but did not think to buy the 29-year. So Mr Meriwether sold 30-year Treasuries and bought 29-year Treasuries and waited for the gap to close.

For a while LTCM was outstandingly successful. Over time, it found 38,000 of those mispriced pairs. In 1996 alone LTCM's investors made a profit of $1.6 billion. By 1998 it had so much money that it returned more than a third of its $7 billion in capital to its investors. But in August 1998 Russia defaulted on its debt, sending financial markets into a frenzy. LTCM began to lose money. According to Charles Ellis, the author of the Goldman book, in the second week of September its losses were as follows:

Thursday 10th: $145m
Friday 11th: $120m
Monday 14th: $5m
Tuesday 15th: $87m
Wednesday 16th: $122m

LTCM's collapse was the credit crunch in miniature:

• The fund depended on debt. Its real return in that bumper year of 1996 was a modest 2.45%. It made so much money because only $4 out of every $100 was equity. Earning $2.45 of profit on $4 of equity is pretty good. Unfortunately, as LTCM discovered, equally small losses could wipe out the fund.

• It was secretive. LTCM traded each half of its pairs with separate brokers because it did not want anyone copying its strategy. That was an advantage when it was riding high. But when the tide turned, its brokers wanted more security, as they could not judge the risk of its pairings and its hedges.

• In a crisis everything correlates. LTCM's asset pairs should have been independent of each other. But when Russia defaulted, the whole market bolted for safety. LTCM had been buying the less liquid of each pair of assets and selling the more liquid. Suddenly all its positions were in trouble at once.

• LTCM failed to grasp how much it was affecting the market. Allegedly Goldman Sachs and others eventually began to copy LTCM. When it got into trouble and had to start unwinding its bets, others sold first. Its own positions were so big that its selling put further pressure on prices. Whereas the prices of asset pairs should have converged, they were forced further apart, making LTCM's losses even bigger.

After Wall Street bailed LTCM out, Mr Meriwether quoted his colleague, Victor Haghani, on how other firms had traded against it: "The hurricane is not more or less likely to hit because more hurricane insurance has been written. In the financial markets this is not true. The more people write financial insurance, the more likely it is that a disaster will happen, because the people who know you have sold the insurance can make it happen."

It was an example of something that Mr Soros calls “reflexivity”. Once people come to believe that house prices never fall, they will buy too much property—and house prices will fall. When they believe that shares always do well in the long run, they will buy too many shares—and the market will do badly for years. When funds believe that diversification always pays, they all invest in the same exotic instruments. Diverse markets suddenly have something in common: the funds that have bought into them.

People often talk about financial markets as if they were casinos, but reflexivity makes them much more dangerous than any gambling den. The numbers on a roulette wheel never change, but markets offer no guarantee that yesterday’s odds will be the same tomorrow.

How to play chicken and lose

Jan 22nd 2009
From The Economist print edition

Finance suffers from reverse natural selection

Illustration by S. Kambayashi



THE great American economist Irving Fisher was never able to live down his remark, just before the 1929 crash, that share prices had reached what seemed “a permanently high plateau”. Fisher’s shoes have been filled by Chuck Prince. “As long as the music is playing,” the then head of Citigroup told the *Financial Times* just weeks before the credit markets seized up in August 2007, “you’ve got to get up and dance.” Then he uttered his fatal coda: “We’re still dancing.”

It was a silly thing to say. Before the year was out Mr Prince had resigned over Citi’s losses. But it was not a silly thing to believe. In financial services, wallflowers are losers. A bank of Citi’s size cannot sit out the boom without confronting commentators and investors alike. The winner is more likely to be the bank that dances in the hope that it can scramble to a seat when the music stops (even if, as in this crisis, there are virtually no seats).

Financial services will always be a tug-of-war between two contradictory promises: “Your money is safe with us” and “We will earn you higher returns.” The disturbing truth behind Mr Prince’s words is that bit by bit a boom kills off those who tend towards safety. The survivors, meanwhile, go for returns, because as long as the sky is clear financial-services companies grow by earning money.

Since the 1970s Wall Street’s tug-of-war has grown fiercer. The industry in America—and hence in the City of London, Frankfurt and Paris—has evolved from a guild of small partnerships trading in semi-rigged markets into a joust of giant multinationals and clashing egos. Competition has led to innovation and lower charges. It has increased the supply of credit, which boosts economic growth. But the job of managing financial-services powerhouses—keeping people’s money safe as well as making a good return—has become harder than ever.

The good old days

In 1970 Goldman Sachs had about 1,300 people. At the end of last year it had roughly 30,000. In 1971 Morgan Stanley had about 3,500 people; at the peak, in 2006, it had 55,000. Although boutiques such as Perella Weinberg have sprung up in the intervening period, the story of commercial and investment banking has been broadly one of consolidation.

Roy Smith, a finance professor at NYU Stern School of Business in Manhattan, has counted no fewer than 28 takeovers of once-important commercial and investment banks since 1977. Kuhn Loeb, White Weld and Donaldson, Lufkin & Jenrette have all disappeared, as have Solomon Brothers, First Boston and Kidder Peabody. Firms also built up their capacity to trade in the secondary market, at first so they could

make markets and later to earn profits on their own account. As the demand for capital grew, the partnerships were tempted to list their shares. The old Wall Street was lost.

It would be a mistake to idealise the partnerships. Samuel Hayes, of Harvard Business School, points out that after the second world war the fees for many operations were fixed. Underwriting syndicates for raising capital were predetermined for each client. If a minor but ambitious firm like Salomon Brothers tried to by-pass the managing underwriter and go direct to a client, the underwriter would ostracise it and give it a bad name on Wall Street. Managed competition gave the firms an incentive to regulate themselves. Future profits depended on the status quo, which had to be protected. That produced stability, but at what cost to clients?

On the other hand, partnerships really were easier to run, because the firms were small and their business was straightforward. To the critics of modern-day investment banking, their virtue lay in the fact that their senior managers were also their owners. They were not gambling with shareholders' money.

The argument is that managers in recent times took excessive risks because they did not own their firms. Moreover, their pay gave them huge incentives to gamble with the business. In "Liar's Poker", his tale of Salomon Brothers in the 1980s, Michael Lewis records the words of a senior trader who worked for Lew Ranieri, the creator of mortgage-backed securities: "At other places management says, 'Well, gee, fellas, do we really want to bet the ranch on this deal?' Lewie was not only willing to bet the ranch, he was willing to hire people and let them bet the ranch too. His attitude was: 'Sure, what the fuck, it's only a ranch'."

In fact, the argument about ownership and pay is not entirely convincing. It is true that pay was large—far too large, it is clear, now that so many of the profits bankers earned in the bountiful years have turned out to be illusory. But a bubble that inflated revenues, share prices, fees, profits and employment was bound to inflate pay too. By the same logic, today's bust will lower it.

The incentives were more complex than to bilk shareholders by betting the ranch every time. Managers at Bear Stearns and Lehman Brothers were not partners, but they still owned large slugs of the business. Jimmy Cayne, Bear's chief executive, personally lost more than $1 billion in its collapse; Dick Fuld, his counterpart at Lehman, is believed to have lost a similar amount. Although traders are overwhelmingly paid in cash, the managers who are supposed to oversee them take about half their bonuses in share options and shares that they are not allowed to sell for three to four years. Many outfits frowned on employees selling shares even when they were formally allowed to do so. After only a few years at a bank, most managers would have a large part of their wealth tied up in the firm's survival.

The end of partnerships turned private rivalries into a public tournament. The senior managers' wealth, careers and status were completely wrapped up in their firms' pre-eminence. League tables, quarterly results, daily share-price movements, total shareholder returns, all are ways of keeping score of who is up and who is down. If you did not compete, you were a dullard. If you pulled back, your career might be cut short. Not for nothing did they call the conservative Brown Brothers Harriman, the grandest remaining partnership, "the cemetery with the lights on".

Rather than being victims, shareholders may well have driven managers on. Hans-Werner Sinn, the head of Ifo, an economic research institute in Munich, argues that limited liability gives them a reason to flirt with disaster. The creditors of a failed firm have no claim on the personal assets of its shareholders. So if the bank takes big risks that promise big profits, its shareholders stand to enjoy the full gains but to bear only part of the losses. By contrast the shareholders of low-risk, low-return banks that never collapse have to bear all the losses.

George Gilbert Williams, long-time head of Chemical Bank in New York in the 19th century, once explained that his success was founded on "the fear of God". But as a boom takes its course, fear is supplanted in what a senior quant at an American bank calls the "Cassandra effect". The more you warn your colleagues about the tail risks—the rare but devastating events that can bring the bank down—the more they roll their eyes, give a yawn and change the subject. This eventually leads to self-censorship. "The system", he says, "filters out the thoughtful and replaces them with the faithful."

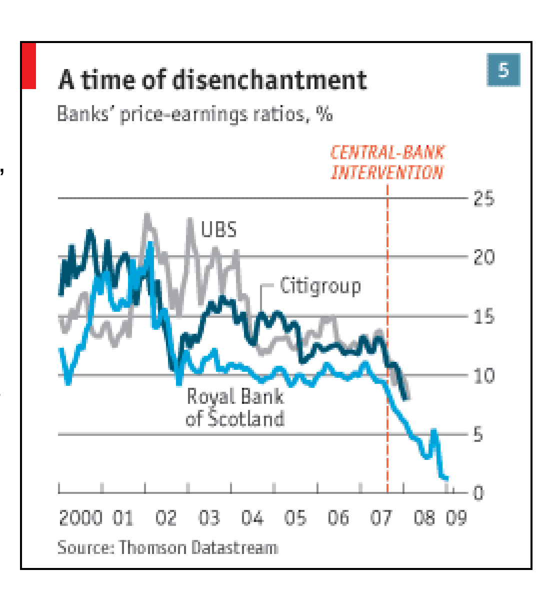
Unwelcome advice

Models might look objective, but each has its own context—to make a sale, bear down on an impulsive

trader and so forth. Andrew Lo, a professor at the MIT Sloan School of Management, imagines a confrontation in 2004 between the head of Lehman and its chief risk officer. Foreseeing a catastrophe ahead, the risk officer proposes shutting down the mortgage business, but his boss threatens to sack him on the spot. He suggests cutting back, but the boss counters that his competitors are expanding and his best people would be poached. He mentions hedging the risk, but his boss retorts that in the next two years that will cost hundreds of millions of dollars in lost profits.

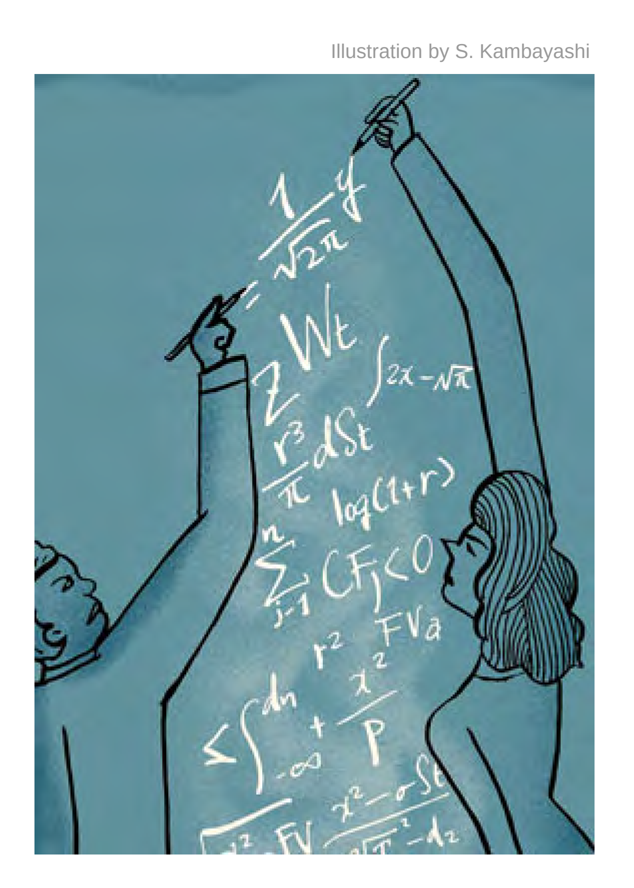
The risk officer's analysis would be hard for all but partnerships, private companies and Warren Buffett to follow (and even the veteran investor's reputation was tarnished when he sat out the dotcom boom). To paraphrase Keynes, if you work in finance the market can stay irrational longer than you can stay in your job.

As managers built financial conglomerates and sought to push them ever harder, the quality of earnings in their industry was deteriorating (see chart 5). Most of the large outfits have struggled to create an *esprit de corps*. Alan Johnson, a pay consultant who specialises in finance, describes a trading room of, say, 1,000 people. Fifty of them might be over 40 years old and just ten over 50. Their typical career might peak after five to seven years. Charles Ellis, author of the recent book on Goldman, thinks traders' focus has narrowed as rewards have gradually shifted from the team and the year to the trader and the individual trade. People may well not know, understand or care about the business of the traders on the next desk. Mr Ellis thinks that the sorts of people who go into finance these days are different from their predecessors—more transactional, cleverer and less strategic.



Sometimes the top brass mismanaged the detail. According to Mr Derman, rivals copied innovations within months, so the arms race in modelling tended to lead to complexity, because you could charge more for it and because complexity is harder to reverse-engineer. Yet complexity can be dangerous. Citigroup came a cropper when it sold "liquidity puts" along with its CDOs. These gave the buyers the right to hand the CDO back at the original price if the market collapsed. They looked like a tweak that would enable the bank to extract a slightly higher return, and Citi's most senior managers knew nothing about them. The liquidity puts ended up costing the bank a king's ransom when $25 billion-worth of CDOs came back on to the balance sheet.

Illustration by S. Kambayashi



But the strategy too was sometimes poorly handled. It started perfectly well in the 1970s with Walter Wriston at First National City Bank, later renamed Citicorp. Wriston trained an entire generation of bankers who wanted to make better use of their capital and to grow faster. More recently, commercial and investment bankers have contracted a bad case of Goldman envy. As a result, senior managers have demanded double-digit increases in sales and profits year in, year out (rather as investors, stricken with Yale envy, sought to match the returns of the university's endowment fund by pouring money into private-equity and hedge funds). Stern's Mr Smith points out that the growth imperative required volumes for each product to be big, as they were in mortgage-backed securities and leveraged loans. Some of the worst mistakes befell banks like Citi, UBS and Merrill Lynch which were told from on high to catch up in mortgage finance. Woe betide any banker who fell behind.

An internal investigation into $38 billion of mortgage losses at UBS, ordered by the Swiss Federal Banking Commission, blamed the disaster on a push for growth in the bank's fixed-income business. The CDO desk piled into "mezzanine" tranches of the securities, which paid more but ultimately lost more too. At its peak the CDO desk had only 35-40 people, but it amassed around $12 billion of write-downs in 2007, two-thirds of that year's total.

Over the past 35 years it has seemed as if everyone in finance has wanted to be someone else. Hedge funds and private equity wanted to be as cool as a dotcom. Goldman Sachs wanted to be as smart as a hedge fund. The other investment banks wanted to be as profitable as Goldman Sachs. America's retail banks wanted to be as cutting-edge as investment banks. And European banks wanted to be as aggressive as American banks. They all ended up wishing they could be back precisely where they started.

The uneven contest

Jan 22nd 2009
From The Economist print edition

Financial regulation is essential. That does not make it easy

Illustration by S. Kambayashi



FINANCE is the machine that governs the economy, but it is unstable and dangerous. The managers of banks and other financial outfits cannot be trusted to counter the euphoria of investors, yet governments feel compelled to throw money at a bust. The case for regulation, in a nutshell, is that financiers make mistakes and everyone else has to pay for them.

Regulators start with some obvious advantages: the resources of the state, the backing of the law, access to confidential information and, for the time being at any rate, a supersized helping of moral authority. The last of those is temporarily convertible into budgets and reform. If regulators feel they need new powers, there could be no better time to secure them.

Yet the crisis has also shown that regulators are condemned to labour under many disadvantages. Some of these can be put right, but many are beyond the reach of any reform. Given the financial system's fallibility, regulation is bound to be fallible too. This is an important point. Expecting perfection of regulators undermines their authority when they fall short.

The most sensational regulatory failure of modern times is the alleged scam by Bernie Madoff. The Securities and Exchange Commission failed the investors he supposedly swindled over many years. Some of those investors were private citizens who depended upon the SEC. But others were professionals who charged their clients large fees to tell them where to put their money. Those professionals, too, failed to rumble Mr Madoff.

The world always seems to ascribe financial success to superior intelligence. Were the fund managers seduced by Mr Madoff's reputation and his list of investors? Were they impressed by his apparently safe, dependable returns? Were they fearful of looking stupid by questioning his strategy or, worse, his probity? A regulator like the SEC should not have been swayed by such things, especially if it had been warned by one of Mr Madoff's rivals, but the agency is staffed by people who are worse-paid and almost certainly worse-qualified than the elite professionals who were swayed too. As Ronald Cass, a former dean of Boston University School of Law, has argued in the *Wall Street Journal*, Mr Madoff looks as if he broke plenty of laws that are already in force. His ability to mislead everyone around him "illustrates the limits of law, not the need for more of it".

Regulators are not the impartial, omniscient judges that legislation so often presumes. How could they be? In banks even senior managers have often lacked the timely and detailed information they needed to rein in their own traders. Regulators would struggle to do any better. They live in the financial markets. Many of them come to see the world in the same terms as their charges do. Rather than cast doubt on their own judgment by announcing that a long-held practice has ended in humiliation, regulators are

tempted to hang on just a little bit longer.

Who dares, wins

In a fight, the regulators have the legal power. But the financiers have the political power, at least when there is no financial crisis in progress. The industry stands to make or lose large sums if the rules are changed, whereas everyone else has got better things to worry about than financial regulation. The wealthy and well-connected people on Wall Street, fine citizens and generous donors, usually get their way.

It helps that the intellectual fashion has been for deregulation and free markets. Politicians such as Phil Gramm, formerly a senator from Texas, sponsored the repeal of the Glass-Steagall act, a Depression-era separation of investment and retail banking. That move has since come under attack as the sort of “market fundamentalist” project that caused the bubble. However, the supporters of the repeal argue that it was really a first step towards modernising a system which had outgrown Glass-Steagall. The original act described the world in categories that no longer fitted the industry it was supposed to regulate. The problem was not so much deregulation but regulation’s failure to evolve with the so-called “shadow banking system”.

This is a nexus of private-equity and hedge funds, money-market funds and auction-rate securities, non-banks such as GE Capital and new securities such as CDOs and credit-default swaps. It was erected over decades, partly on useful innovations and the desire for higher returns and partly as a way to avoid the cost of regulation. On the eve of the crash, more capital was flowing through it than through the conventional banks. Now that it has imploded, the banks cannot fill the hole.

To see the system at work, look at auction-rate securities, a sort of long-term debt invented in the 1980s. The innovation was to set the interest rate in an auction, typically every seven, 28 or 35 days, giving lenders the chance to sell out each time. In theory, this offered the best of both worlds. Borrowers got long-term debt at near short-term interest rates. Lenders got almost instant access to their cash at a higher yield. At its peak the market was worth some $330 billion.

Paul Krugman has pointed out that when you strip this trick down you are left with a bank loan. On one side are depositors, who expect to get their cash back pretty much whenever they want. On the other are long-term borrowers. Hundreds of years of banking history attest to the instability of this “maturity transformation”. Sure enough, in February 2008 the auctions began to fail when there was a dash for cash. Suddenly lenders found that nobody wanted to buy their loans, so they could not get hold of their money. If the market for auction-rate securities had been a bank, you would have said that it had suffered a run. Yet auction-rate securities were not regulated like banks.

Time after time the market seems to have found ways to work around regulation. Banks paid insurers such as AIG to take on the risk that their assets would default, which saved them having to put capital aside as the regulations required. This neatly converted lower-rated securities into AAA ones—except that AIG almost went bust. The banks and insurers who sold money-market funds had promised their investors that, as with bank deposits, they would at least get their money back. When one fund broke that promise after Lehman Brothers collapsed, the run on money funds threatened to do so much damage to the credit markets that the Fed felt compelled to step in.

Too many knee-jerks

If something needs rescuing, it is a sign that it needs regulating. By that test, an awful lot needs to be rethought after this past year. The rescues of banks, insurers and mortgage lenders have also left some cleaning up to do. It seems harsh to criticise decisions improvised under pressure over a series of autumn weekends, but the authorities were inconsistent. The rescue of Bear Stearns wiped out the common shareholders. The rescue of Fannie Mae and Freddie Mac junked both the common shares and the preferred shares (which rank above them in a bankruptcy). With Lehman Brothers, everyone lost their money. When AIG was saved, only the common shareholders suffered. But the bail-out of Washington Mutual hit both shareholders and senior-debt holders.

Any rescue is a balance. The immediate aim, to support the system, suggests an indiscriminate bail-out. Even punishing shareholders is counterproductive, because that makes raising capital harder just when

capital is what the financial system needs most. On the other hand, capitalism requires the possibility of failure. Investors must pay for their mistakes.

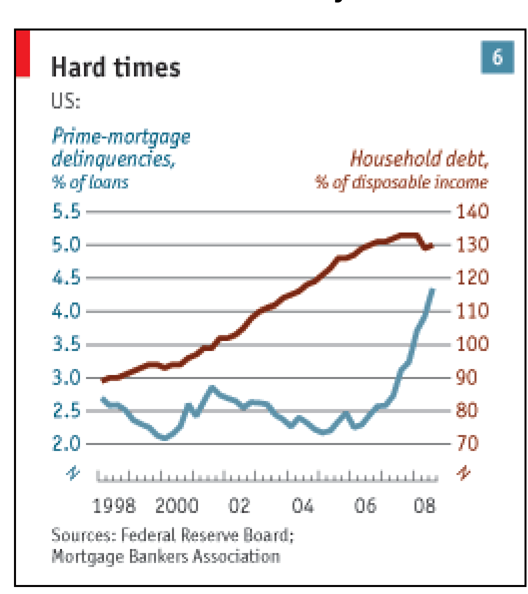
The authorities' inconsistency left everyone guessing about whom they would rescue and how. It spread uncertainty among potential lenders and hope among petitioners. If you had been about to buy senior bank debt, it meant that you would think twice. If, like the car industry, you wanted a soft loan, you were encouraged to press your case.

After the rescues, the state is now the biggest owner of bank shares in many economies. Some governments may be tempted to direct their banks' lending, especially if the credit markets are not working. And forced mergers and rescues have created some banks that are unambiguously too big to fail. The market will break some of these apart, as at Citigroup. But regulators need to re-establish the idea that intervention is based on rules. The best way to do that is through re-regulation.

Fixing finance

Jan 22nd 2009
From The Economist print edition

The world now has a chance to make finance work better. It should tread carefully



THE world is only beginning to count the cost of the bust. In America the share of household and consumer debt alone went up from 100% of GDP on 1980 to 173% today, equivalent to around $6 trillion of extra borrowing, according to Martin Barnes of BCA Research, a Canadian investment-research firm. Chart 6, from Merrill Lynch, shows the growing burden on households. Some of this extra debt was the healthy outcome of a deepening financial system. It was bearable while households appeared to be getting richer, thanks to inflating house and share prices. But now it has become too much of a burden.

At the same time the financial-services industry is condemned to suffer a horrible contraction. In America the industry's share of total corporate profits climbed from 10% in the early 1980s to 40% at its peak in 2007. Its share of the stockmarket's value grew from 6% to 23%, according to Mr Barnes. It is hard to believe that financial services create enough value to command such pre-eminence in the economy. At the peak, the industry accounted for only 14% of America's GDP and a mere 5% of private-sector jobs.

Financial markets are still in distress. Although some assets, such as good-quality corporate debt, seem cheap, nobody is buying them. Perhaps that is because valuations are so confusing, with assets priced far outside their familiar range; or perhaps it is because people expect prices to fall further. Meanwhile, rescues are the priority as the authorities rightly guard against one collapse triggering others, as seemed possible after Lehman went down. The banks will need even more government money.

The underlying malaise is a retreat from debt. The "deleveraging", as household savings grow and the financial-services industry sheds debt, will mean that people spend less. Their prudent saving will destroy companies and jobs—Keynes's "paradox of thrift". Nobody can say where the new floor for debt will lie, just that finding it will be painful.

André Sapir, of the Université Libre de Bruxelles, recently told a *Financial Times* conference that government policy should not be aiming to avoid a repeat of 1929: it has already failed to do that. Instead it should aim to avoid 1930-32. Taxpayers will end up carrying the load. In effect, the state will take on much of the debt that the private sector has decided to jettison. Some people will complain about that, but it makes sense to borrow to bring government spending forward. Just now, such public spending will hardly be crowding out the private sector: businesses find it impossible to borrow anyhow.

Higher government spending may save the world economy from a depression, but it cannot prevent a long hangover. The meltdown of 2008 is likely to cause a freeze during which credit refuses to grow. This could look like the aftermath of the Depression, when credit and trading in financial markets barely increased. James Grant, a financial commentator, has called those years the "inconsolable era" of American finance.

Illustration by S. Kambayashi



During that time the task will be to re-regulate finance. This will demand a large amount of spadework as well as one strategic choice. The spadework should aim to put right the failings of today's regulation, which often owes more to politics than it does to sound finance. In America, for instance, the insurance industry is regulated by the states; AIG's capital-markets group, which lost all that money insuring CDOs for foreign banks, fell between stools. Similarly, futures come under one regulator, jealously guarded by its own congressional committees, and stocks under another. The status quo suits many interests, but the plan to reorganise America's regulators put forward by Hank Paulson, the recently departed treasury secretary, deserves a good hearing.

Everywhere, countries need to look at their mortgage markets. As housing recovers, they should phase out tax relief on mortgage payments. America should give mortgage lenders a claim on more than just the borrower's house, so as to deter speculative buying. At the same time, mortgage origination should be tightened up: too often lenders connived with borrowers to swell the size of mortgages, or worse, sell borrowers the wrong policy. Stopping housing from being a subsidised asset may not prevent booms or mis-selling—after all, unsubsidised Britain saw one of the bigger booms—but it should moderate them.

The presumption should be for transparency. That favours market-based accounting (which, for all its faults, is better than sweeping losses under the carpet). Securities such as credit-default swaps which trade in huge volumes should pass through clearing houses. That would have the added benefit of limiting the damage from a collapse, since the default would pass to the clearing house too. The system can be made more robust in other ways. Rather than regulate institution by institution, as at present, the authorities need to watch the overall level of credit creation and leverage. In this spirit, regulators can push against a boom by asking banks to hold more capital (though the markets will be pushing in the other direction). Senior financiers could take more of their pay in equity—and hand some back if the bank does badly.

To mitigate future crises, the system needs to cope with capital flows by introducing reforms in emerging markets. And the rich world should aim to get the politics of regulation right for the long haul. The next 18 months to two years will offer a rare chance to do that. The rules need to be able to evolve along with the financial services themselves. That means regulating by function rather than by institution: if something looks like a bank, it should be treated like one. If a hedge fund or any other type of fund looks large enough to threaten the system, it will need watching.

Andrew Lo, of the MIT Sloan School of Management, wants a government board to study "near misses" like Long-Term Capital Management. And national regulators could take strength from their international counterparts. A single supranational regulator is out of the question—indeed it may not even be wise to have one, as limited competition between regulators is useful. But international standards can guide domestic regulators.

Behind this spadework lies a strategic choice. The cheerleaders of finance were unwilling to admit that houses were too expensive and risk too cheap. On the other hand the critics of finance have been too swift to blame everything on their pet hates—deregulation, market fundamentalism, globalisation, whatever.

Pick your crisis

Centuries of boom and bust show that you cannot avoid financial crises altogether, but you can exercise

some choice over what kind of crisis you get. Charles Wyplosz, professor of economics at the Graduate Institute in Geneva, envisages a spectrum, with an innovative, lightly regulated but crisis-prone financial system at one extreme and a stable, heavily regulated but stodgy one at the other. Depression-era America tried to tame finance's most dangerous traits by moving towards safety. Gradually, modern finance has reversed that shift, creeping towards innovation and light regulation. There will now be strong calls to restore some of the old values. Is that the best balance to strike?

The answer depends on what you think you gain from innovation and lose from crises. Is it better to be a hare, scampering in fits and starts, or a tortoise, pressing relentlessly forward? For many people in financial services the choice is obvious. They would like to be free to innovate and make money. In fact, the choice hinges on the interests of the economy as a whole. After all, it is taxpayers and savers who pay for financial crises.

Some people question whether financial innovation is worth very much these days. Willem Buiter, of the London School of Economics, thinks a stripped-down sort of finance could do most of what a modern economy needs. In a remarkable lecture given in 1984, near the beginning of the boom, James Tobin, a Nobel laureate (and Mr Buiter's former teacher), puts the case. His conclusion is worth quoting:

> I [suspect] we are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity. I suspect that the immense power of the computer is being harnessed to this 'paper economy', not to do the same transactions more economically but to balloon the quantity and variety of financial exchanges…I fear that, as Keynes saw even in his day, the advantages of the liquidity and negotiability of financial instruments come at the cost of facilitating nth-degree speculation which is short-sighted and inefficient.

If this is your picture of the world, then you want to constrain finance. You may well want a core of regulated banks that cannot blithely create credit, take on leverage and secrete assets off their balance sheets, as today's banks have done. Although you would allow hedge funds and private equity to experiment, you would seek to contain their mischief by containing their access to capital. The era of Baroque exuberance would be over.

There is, however, another view: a presumption in favour of liberalised markets and innovation. On a grand historical scale, this is hard to argue with. Richard Sylla, a professor of economic history at NYU Stern School of Business in Manhattan, observes how often financial sophistication has gone with military and economic power. Think of 15th-century Italy and its banks; the 17th-century Low Countries; 18th-century British government debt and insurance; 19th- and 20th-century American capital. It is no accident, Mr Sylla says, that when Japan set out to industrialise in the late 1860s, almost the first thing it did was to copy the most advanced Western forms of financial management.

A few economists have set out to put a value on freer finance in the modern world. In a paper published at the end of 2006, Romain Ranciere, of the IMF, Aaron Tornell, of the University of California, Los Angeles, and Frank Westermann, of the University of Osnabrück, concluded that financial liberalisation raises growth by around 1% per person per year. Other studies suggest that financial innovators gain from their discoveries, and that an actively traded stockmarket tends to be a signal of present and future growth.

Valuing freer finance

That is fine as far as it goes, but according to Josh Lerner, an expert in innovation at Harvard Business School, such studies are surprisingly rare compared with studies of technological innovation. Moreover, any academic paper setting out to record the effects of recent financial innovation would have missed the biggest data point of the past 80 years—the present crash. And even if it had not, there are so many factors to consider that the pro-liberalisation case may be hard to prove.

In the end the argument for embracing innovation is conceptual rather than empirical. As a rule, innovation is a source of wealth. It would be odd if financial services were an exception. Arguments in other fields that there is nothing left to discover have usually proved false. You can imagine how computer technology might lead to further financial innovation, even if it also sometimes creates instability. In addition, Mr Lerner believes that financial services need to be adapted to the economy of which they form part, and the economy is always changing. Foreign-exchange derivatives came into their

own, for example, when exchange rates floated after 1971.

And even if you admire stripped-down finance, regulators cannot hold the line for ever. Ultimately, they are likely to lose ground to financiers who will use arbitrage to work their way around the best-laid defences. Hard as it is to acknowledge at the moment, in the teeth of a recession, the judgment of Clément Juglar, a 19th-century French business-cycle theorist, has the ring of truth: “The richness of nations can be measured by the violence of the crises which they experience…”

Looking back from the pit of recession, it is difficult to recall how the investment banks’ pre-eminence and the hedge-funds’ wealth could ever have seemed to be the natural order. A time will come when today’s fear is equally hard to fathom. Greedy once again, people will wonder why they did not buy shares at that price, why they did not realise corporate bonds were a steal and why they did not foresee a bout of inflation or a weak dollar.

Such shifts in perception are the result not of madness or criminality, but of individually rational responses to what Keynes saw as the inherent uncertainty in financial markets. Finance feeds on trust and mistrust, and amplifies whichever is ascendant. That is what makes financial markets dangerous.

Just now that probably seems like a reason to tie finance down. And indeed it could be better regulated, as the crisis has shown. But a thoroughgoing effort to tame finance would be futile and could come at a high cost. Frederic Mishkin, a former Fed governor, once called finance “the brain of the economy”. The image conjures up power and importance, but it also evokes complexity and fragility. Finance is a remarkable creation. Do not suppress it, but use it wisely.

Sources and acknowledgments

Jan 22nd 2009
From The Economist print edition

The author would like to express particular thanks for their help with the preparation of this special report to Tim Bond, Kristin Forbes, Andrew Gracie, John Gutfreund, Stephen Haber, Jan Hatzuis, Pierre Lagrange, George Magnus, Randy Quarles, Ken Rogoff, Manny Roman, Andrew Rose, Josh Rosner, Paul Ruddock, Huw van Steenis, Peter Wallison and Christopher Whalen.

Sources

Barth, J., Caprio, G. and Levine, R. (2002), "Bank Regulation and Supervision: What Works Best?", NBER Working Paper No. 9323

Berndt, Antje and Gupta, Anurag (2008), "Moral Hazard and Adverse Selection in the Originate-to-Distribute Model of Bank Credit"

Bernstein, Peter (1998), "Against the Gods: The Remarkable Story of Risk", Wiley

Bookstaber, Richard (2008), "A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation", Wiley

Derman, Emanuel (2004), "My Life as a Quant: Reflections on Physics and Finance", Wiley

Ellis, Charles (2008), "The Partnership: The Making of Goldman Sachs", Penguin Press

Frame, Scott, and White, Lawrence (2004), "Empirical Studies of Financial Innovation: Lots of Talk, Little Action?", *Journal of Economic Literature*, Vol. 42, No. 1 pp. 116-144

Galbraith, John Kenneth (1994), "A Short History of Financial Euphoria", Penguin

Grant, James (1996), "The Trouble with Prosperity: A Contrarian's Tale of Boom, Bust and Speculation", Times Books

Grant, James (2008), "Mr. Market Miscalculates: The Bubble Years and Beyond", Axios Press

Greenspan, Alan (2008), "The Age of Turbulence: Adventures in a New World", Penguin

Ivashina, Victoria and Scharfstein, David (2008), "Bank Lending During the Financial Crisis of 2008", Harvard Business School

Kashyap, Anil; Rajan, Raghuram and Stein, Jeremy (2008), "The Global Roots of the Current Financial Crisis and its Implications for Regulation"

Kaufman, Henry (2007), "The Paths of Financial Glory", Henry Kaufman & Company

Kaufman, Henry (2008), "The Financial Crisis: Causes and Remedies", Henry Kaufman & Company

Kaufman, Henry (2008), "The Financial Consequences of the Credit Crisis", Henry Kaufman & Company

Kindleberger, Charles and Aliber, Robert (2005), "Manias, Panics and Crashes: A History of Financial Crises", Wiley

Krugman, Paul (2009), "The Return of Depression Economics and the Crisis of 2008", W.W. Norton & Company

Lerner, Josh (2006), "The new financial thing: The origins of financial innovations", *Journal of Financial Economics* 79 223–255

Levine, R (1996) "Financial Development and Economic Growth: Views and Agenda", Policy Working Research Paper 1678, The World Bank

Lewis, Michael (2008), "Panic: The Story of Modern Financial Insanity", W.W. Norton & Company

Mandelbrot, Benoit and Hudson, Richard (2006), "The Misbehaviour of Markets: A Fractal View of Financial Turbulence", Basic Books

McKee, Bob and Roche, David (2007), "New Monetarism", Lulu Enterprises

Merton, Richard (2005), "Financial Innovation And Economic Performance", *Journal of Applied Corporate Finance* Volume 4 Issue 4, Pages 12 - 22

Perez, Carlota (2002), "Technological Revolutions and Financial Capital", Edward Elgar

Ranciere, Romain; Tornell, Aaron and Westermann, Frank (2006), "Decomposing the Effects of Financial Liberalisation: Crises vs. Growth", NBER Working Papers 12806

Soros, George (2008), "The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What It Means", PublicAffairs

Tanzi, Vito (2005), "Regulating the New Economic Order: The Good, the Bad and the Damaging", Politeia

Tarullo, Daniel (2008), "Banking on Basel: The future of International Financial Regulation", Peterson Institute

Tobin, James (1987), "Policies for Prosperity; Essays in a Keynesian Mode", Edited by Peter M. Jackson, Wheatsheaf Books, pp. 282-296

Tufano, Peter (1990), "Financial Innovation and First-Mover Advantages", Harvard Business School

Wolf, Martin (2008), "Fixing Global Finance" (Forum on Constructive Capitalism), Johns Hopkins University Press

Offer to readers

Jan 22nd 2009
From The Economist print edition

Buy a PDF of this complete special report, including all graphics, for saving or one-click printing.

The Economist can supply standard or customised reprints of special reports. For more information and to place an order online, please visit our Rights and Syndication website.

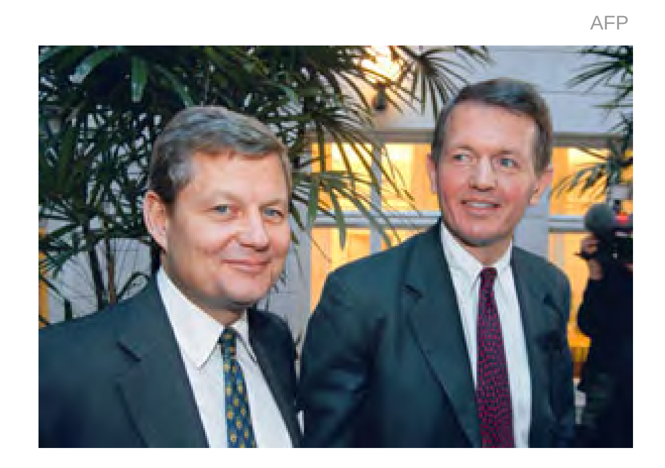
The Wallenbergs

The ties that bind

Jan 22nd 2009 | STOCKHOLM
From The Economist print edition

Sweden's business dynasty is weathering the financial crisis pretty well. Does this demonstrate the superiority of old-fashioned family capitalism?

AFP



THE day his family almost lost its bank is still fresh in the mind of Jacob Wallenberg, one of the fifth generation of a dynasty that controls almost a third of the value of companies on the Swedish stockmarket. It was in 1993, in the depths of Sweden's banking crisis, and accountants were totting up the results for Skandinaviska Enskilda Banken (SEB), upon which the Wallenbergs' business empire had been built a century and a half earlier. The bank's capital ratio was being steadily depleted by a torrent of bad debts. If it fell below 8%, the bank would probably be nationalised. When the final tally came, the figure was 8.04%. "There was a deep sigh of relief," Mr Wallenberg recounts.

That crisis taught Mr Wallenberg, who is now chairman of Investor, the family's main investment-holding company, two lessons. The first was that cosy links between companies are all fine and good, but when it comes to the crunch, cash is king. "Relationships are great, but cashflow is even better," he says. The second lesson was to remember that "sometimes life can turn sour", and to be prudent. Almost two decades later, with rich economies around the world deep in a slump that closely echoes the one Sweden went through, the Wallenbergs are still well served by their hard-learned lessons. Neither of the family's main companies, SEB or Investor, is completely unscathed. Yet they seem to be weathering the crisis better than most.

Although SEB holds some worrying loans, the overall quality of its book is enviable. A ranking by Keefe, Bruyette & Woods, an investment bank, puts its proportion of bad debts at 0.8%, among the lowest in Europe, and about a third of the average of its peers. For its part Investor, which released its annual results on January 20th, said the value of its underlying investments had fallen by about a quarter in 2008. In most years that would be a disaster. Yet when set against a 40% slump in the Swedish stockmarket (and falls of 30% or more in most big markets), it looks quite good. It looks even better when contrasted with private-equity firms' performance.

The main reason for Investor's resilience is that it entered the downturn flush with cash, giving it the means to support struggling subsidiaries and buy distressed assets at knock-down prices. Much of the money was raised by selling assets when markets were near their peaks. Early last year it sold its stakes in Scania, a truckmaker, and OMX, a Nordic exchange operator. Investor's prudence may be a comfort to its shareholders today, yet for some time it was a source of great aggravation. Many criticised it for being slow to do deals in the buy-out boom and for sitting on too much cash. In this regard it was not alone.

What made Investor exceptional, however, was not that its managers were necessarily more prescient than others (though Investor's chief executive, Börje Ekholm, gave warning well before the crash that debt was too cheap and assets too pricey). The chief reason was that it could resist pressure from outside

investors, because it is almost impossible to take over. A dual-shareholding structure gives the Wallenberg family and their charitable foundations more votes per share than other shareholders, and allows them to maintain control of Investor even though they own only about a quarter of its shares.

Admirers of family-controlled companies say Investor demonstrates two of their big advantages: they are able to take longer-term decisions without worrying about being taken over or meeting short-term profit targets, and the interests of managers and shareholders are well aligned. Among the boosters of such companies is Credit Suisse, an investment bank, which in early 2007 launched an index of publicly listed family firms, saying they have proved to be more profitable than their widely held peers (those in which no single shareholder owns more than a 10% stake). But enthusiasm for family-controlled firms should be tempered with caution, for their record is not unambiguously positive—and because Investor is an unusual example of the breed.

It is true that family-controlled companies that are run by their founders usually generate higher returns than widely held ones. An influential study by researchers at Harvard and Wharton business schools found just that in 2004. But it also found that once management control passes to the second generation, they generally perform worse. This trend is exacerbated when dual-stock structures or other convoluted methods are used to maintain control. In the long run, being shielded from takeover breeds inefficiency.

That Investor has survived beyond its third generation, while still generating good returns, makes it all the more unusual. One reason may be that its shareholding is extraordinary, too. In 1917 Knut Wallenberg set up the first, and biggest, of the charitable foundations that have become repositories for most of the family's wealth. Jacob and his cousin Marcus, today's generation, wield enormous influence, but their prosperity is largely of their own making. In that sense they are founders or employees, not just descendants. In line with family tradition, most of their assets will probably go into foundations too, leaving the next generation to start afresh and avoiding the infighting that can arise in business dynasties (see article).

The influence of the professionally run charitable foundations may also be a deciding factor in making Investor unique, for the foundations are ultimately the biggest winners or losers from the decisions of Investor's managers. As such they exercise closer oversight of the company than they might if it were either widely held or simply run by family members for their own benefit. Moreover, the charitable foundations, like university endowments, plan to be around for ever, and take a long-term view that gives managers more leeway. The danger is that more leeway may mean more rope. After all, it was not long ago that even the house of Wallenberg came perilously close to losing its bank.



BUSINESS

The car industry

An Italian lifeline

Jan 22nd 2009
From The Economist print edition

A good deal for Fiat may still not be enough to save Chrysler

Reuters



FIAT'S Sergio Marchionne may not exactly be putting his money where his mouth is, but he is staking his reputation as a consummate dealmaker. Last month he declared that the immediate prospects for the car industry were so dire that only big producers, with sales of more than 5.5m a year, would remain in the long term—and that Fiat, despite its recent renaissance, was not even halfway there. This week he took a big, bold step intended to ensure the Italian firm's survival by, of all things, forging a strategic alliance with Chrysler, an American firm on the edge of extinction.

In late December Mr Marchionne contacted Cerberus Capital Management, the private-equity firm that, to its infinite chagrin, acquired an 80% shareholding in Chrysler from Daimler in mid-2007. The deal he proposed was nothing less than a lifeline. Chrysler had just been saved from immediate bankruptcy by a $4 billion emergency loan from the American government. But it must produce evidence of a plausible recovery plan by February 17th to avoid having to pay the money back in late March. Only then can it get hold of the further $3 billion it says it needs, without which the Fiat deal will not go ahead. With sales in December falling by more than 50% year-on-year, a nearly empty product pipeline and a damning verdict from *Consumer Reports* about the quality of its existing vehicles, Chrysler had run out of options—until Mr Marchionne called.

Under the terms of the deal, which is still only a memorandum of understanding, Fiat will take a 35% stake in Chrysler in exchange for supplying it with its highly fuel-efficient powertrain technology. Fiat will also make available to Chrysler its small and medium-sized vehicle platforms to be rebadged or reskinned as Chryslers in North America. And it will help Chrysler in overseas markets, such as Europe and South America, where its presence is minimal. Fiat dealers, for example, will sell Jeeps in Brazil and Italy. In the longer term, the two firms will co-operate on a new rear-wheel-drive large-car platform, for use by Alfa Romeo as well as Chrysler. Critically, Fiat will send in a hit squad of executives who know a thing or two about turning round ailing carmakers.

With Fiat's help, Chrysler might just be able to convince a sceptical administration that it has a plan to rectify three of its most glaring weaknesses: an over-reliance on gas-guzzling trucks and sports-utility vehicles, almost total dependence on the North American market and a perilously thin senior management team.

What Fiat gets in return, apart from its "gifted" equity stake (which currently has a book value of precisely zero), is a cheap bridgehead into America, a market it abandoned over 20 years ago—ironically, a little before a previous attempted tie-up with Chrysler came to nothing. One or two Chrysler factories will be converted to build the hot new Fiat 500 (pictured) and two new Alfas, to be sold by Chrysler dealers. With a combined production capacity of more than 4m vehicles a year, Fiat will also get some vital scale economies for its platforms, powertrains and the electrical components made by its Magneti Marelli subsidiary. Comau, Fiat's industrial-automation arm, will sell Chrysler the kit to retool its factories.

Fiat has little to lose. If Chrysler stages a miraculous recovery with its help, Mr Marchionne will have created something similar to Carlos Ghosn's Renault-Nissan alliance at almost no cost other than diverted management time. With an option to increase its stake in Chrysler to 55%, the deal is potentially transformative for Fiat. And if things do not work out and Chrysler slides into bankruptcy, Fiat will have no liability exposure but will be in pole position to pick up the assets it needs to implement its North American strategy at fire-sale prices.

As for Chrysler, it gets something it has not had for a long time—a narrative not entirely devoid of hope. A reality check is, however, in order. As Adam Jonas of Morgan Stanley points out, there is no certainty that American customers will flock to buy rebadged small Fiats. Mr Jonas adds: "Chrysler needs more than just small cars—it needs help with its entire product range."

There is also the question of time. It is highly unlikely that even with exemplary execution those American manufactured "Chrysler-Fiats" can hit the market before late 2011. Fiat has thrown Chrysler a lifeline of sorts, but the American firm may be too far gone, and the storm too fierce, for it to make much difference.

LG v Samsung

Looking Good?

Jan 22nd 2009 | SEOUL
From The Economist print edition

LG Electronics is optimistic about 2009. Samsung, its larger rival, is not

IN A meeting room next to the office of LG Electronics' technology chief, Paik Woo-hyun, a copy of the film "Good Night and Good Luck" sits beside one of the company's flat-panel TVs. Mr Paik is no stranger to showbiz, having won an Emmy award for his digital-TV research. The film's title sums up the way in which South Korea's second-biggest electronics firm, a division of the giant LG Group, hopes to leave its rivals behind. Despite the economic crisis, it sees 2009 as an opportunity to grab market share.

LG hopes to boost its share of the global mobile-phone market to 10% from below 8% last year. (By some estimates it has just overtaken Motorola to become the industry's number three, behind Nokia and Samsung, its local rival.) It also wants to boost its share of LCD TV sales from 10.2% to 14.5%, as strong sales in the Middle East, Brazil, India and China overcome slumping demand in Europe and America.

Samsung Electronics, the corresponding unit of the rival Samsung Group, is much less bullish. After more than a year of intense scrutiny in the wake of corruption scandals involving its controlling family, the humbled conglomerate said this month that its executives would take a 20% pay cut this year. It has also consolidated its various units and reshuffled its management in order to speed up decision-making. Analysts predicted that it would report its first ever quarterly loss on January 23rd.

LG's own results, announced on January 22nd, show that it too is hurting as demand for electronic gadgets slackens. Sony, Japan's electronics giant, is expected to report a record loss for the year to March. Only Apple, the American maker of the iPod, which reported strong results on January 21st, is bucking the trend. Despite reporting its first net loss for seven quarters, LG Electronics says it has no plans to reduce pay, reshuffle managers or cut jobs.

It is older than its larger rival, having been founded, as Goldstar, in 1958, more than a decade before Samsung entered the electronics industry. Samsung went on to become South Korea's best known brand and a magnet for the brightest graduates. LG has repeatedly insisted that it will regain the upper hand. In 1996 it pledged that by 2005 it would be number one "in quantity and quality". Yet its sales in 2007 were $44 billion, compared with $105 billion for Samsung Electronics.

Today Samsung is the world leader in flat-panel TVs and the number two in mobile phones. Mr Paik says Samsung's success is largely due to its memory-chip business, which "worked as a cash cow for them." LG sold its own chip unit in 1999, after the Asian financial crises. LG also made much less of an effort than Samsung to promote its brand, focusing instead on improving its manufacturing efficiency.

Plunging memory-chip prices mean that Samsung can no longer rely on its cash cow, however. And last year the group's patriarch, Lee Kun-hee, resigned after being charged with tax evasion and arranging for shares in Samsung subsidiaries to be sold to his son at artificially low prices in an effort to transfer control to his heir. This took the shine off Samsung's brand.

LG's corporate structure is more transparent. The Koos, its controlling family, were among the first to establish a holding company for their conglomerate, in 2003. Since 2004 LG Electronics has been run by professional managers. Yong Nam, the chief executive since 2007, has hired non-Koreans to run marketing and procurement, and proclaimed English as LG's working language. He likes to ask everyone, from secretaries to division heads, what they think of LG's products. Will his firm's optimistic view of its prospects prove to be far-sighted, or rose-tinted?

Corporate write-downs

The goodwill, the bad and the ugly

Jan 22nd 2009 | NEW YORK
From The Economist print edition

Companies that paid too much for a competitor count the cost

BANKS have taken a uniquely brutal pummelling of late, but they are not alone in having to write down overvalued assets accumulated in the boom. Financial and non-financial firms alike face a reckoning on “goodwill” amassed during the long merger wave that subsided last year.

Goodwill is an intangible asset that represents the extra value ascribed to a company by virtue of its brand and reputation. When one firm buys another, the target’s goodwill—essentially the premium paid over its book value—is added to the combined entity’s balance-sheet. Goodwill and other intangibles on the books of companies in the S&P 500 are valued at $2.6 trillion, or 10% of their total assets, according to analysts at Goldman Sachs.

As the economy deteriorates and more firms trade down towards (or even below) their book value, empire-builders are having to mark down the value of assets they splashed out on in rosier times. A recently announced $25 billion goodwill charge is expected to push Time Warner into an operating loss for 2008, for instance. Michael Moran of Goldman Sachs thinks such hits could amount to $200 billion or more over the cycle. Investors have so far paid little attention to intangibles, but as write-downs proliferate they are likely to become increasingly wary of industries with a high ratio of goodwill to assets, such as health care, consumer goods and telecoms.

How bad things get will depend on the beancounters. American firms used to be allowed to amortise goodwill over many years. Since 2002, when an accounting-rule change ended that practice, goodwill has had to be tested every year for impairment. In this stormy environment, with auditors keener than ever to avoid being seen to go easy on clients, companies are being told to mark down assets if there is any doubt about their value.

The sanguine point out that this has no effect on cashflow, since such charges are non-cash items. Moreover, some investors take goodwill write-offs with a pinch of salt, preferring to look past such non-recurring costs and accept the higher “normalised” earnings numbers to which managers understandably cling. The largest companies are thus able to survive thumping blows that might otherwise floor them, such as the $99 billion loss that the newly formed but ill-conceived AOL Time Warner, as it then was, reported for 2002. But the impact can be all too real, as write-downs reduce overall book value and increase leverage ratios, a particular concern in these debt-averse times.

The effect on the share price depends on the extent to which the market has already absorbed the lost value. On January 19th Royal Bank of Scotland’s shares collapsed as the British government raised its stake and the battered lender said it could report Britain’s largest-ever corporate loss after an impairment charge on its takeover of ABN AMRO, a Dutch bank. And Regions Financial, an American bank, lost a quarter of its value on January 20th after taking a $6 billion goodwill charge on its $10.5 billion purchase of AmSouth Bancorp.

Such hits can also sap investor confidence less directly, by raising awkward questions about managers’ competence. If overpaying hugely for a rival does not count as inept, then what does?

 BUSINESS

L'Oréal and Nestlé

In pursuit of beauty

Jan 22nd 2009 | PARIS
From The Economist print edition

Will Nestlé take over L'Oréal?

IN 1974 the family that controlled L'Oréal, a French cosmetics firm, invited Nestlé, a Swiss food company, to take an indirect holding in the firm. The Bettencourts feared that François Mitterrand, presidential candidate for France's Socialist Party at the time, might otherwise nationalise the firm if he was elected. This defensive move proved to be unnecessary. But as a result, 35 years on, the Swiss food giant may now be poised to seize control of L'Oréal, the world's biggest cosmetics firm and one of France's best-known companies.

In 2004 Nestlé tightened its grip in a new pact with the Bettencourts: it now owns 30% of L'Oréal's shares directly, and the family has 31%. In April this year both sides will be allowed to sell their shares for the first time since 2004, so Nestlé's intentions may soon become clear. Shareholders in the Swiss firm are desperate to work out whether it will buy L'Oréal. Adding to the speculation is a vicious family row between Liliane Bettencourt, the daughter of L'Oréal's founder and the world's richest woman, and her daughter, who will inherit her stake in L'Oréal.

For the time being, Nestlé is prevented from increasing its stake in L'Oréal: neither Nestlé nor the Bettencourt family may buy shares until six months after the death of Ms Bettencourt, who is 86. But it may be in Nestlé's interest to amend the 2004 agreement and pre-empt matters if it wants to buy, says a recent report from Exane BNP Paribas in Paris. It suggests that Nestlé and Ms Bettencourt could take L'Oréal private, with Nestlé ending up with about 60% of the firm. At the moment, L'Oréal's shares are extremely cheap. If Nestlé were to wait, however, L'Oréal's share price would leap on news of Ms Bettencourt's death, making the firm far more expensive to buy.

Would the solid Nestlé, currently a safe haven for investors, be any good at the beauty business, selling "hope in a jar", as the founder of Revlon put it? Its executives have in the past suggested that L'Oréal could fit well alongside its "health and wellness" business. The two firms already operate two joint ventures: Galderma, which makes dermatology drugs, and Inneov, which makes nutritional supplements. That said, the case for acquiring L'Oréal would mainly have to stand on the cosmetic firm's intrinsic merits, according to Exane BNP Paribas.

But buying L'Oréal would be unpopular with many of Nestlé's shareholders, despite its strong brands. The French firm has set its targets for revenue growth too high for several years, says Andrew Wood, an analyst at Sanford Bernstein in New York, and the pressure to meet profit targets led to cuts in marketing and research spending as a percentage of sales. As a result, says Mr Wood, the rate of revenue growth excluding acquisitions has fallen from 8.5% a year during 1999-2003 to 5.7% in the past five years, and L'Oréal has missed its targets for overall revenue in three of the last four years. Nestlé would be taking a bet that L'Oréal could return to historic form, and it might need to invest heavily.

As April approaches, a wild card will be Ms Bettencourt's feud with her daughter, Françoise Bettencourt Meyers. Last month it emerged that Ms Bettencourt Meyers had filed an "abuse of weakness" complaint against a male friend of her mother's, to whom Ms Bettencourt had given money and gifts worth as much as €1 billion ($1.3 billion), according to the French press. Ms Bettencourt has dismissed any notion of incapacity on her part. Theories abound as to what effect the resulting feud between mother and daughter, both of whom sit on L'Oréal's board, will have on the firm's ownership. Family discord might make Ms Bettencourt more likely to cede control to Nestlé, but it might also prevent any deal being done before her death, analysts say.

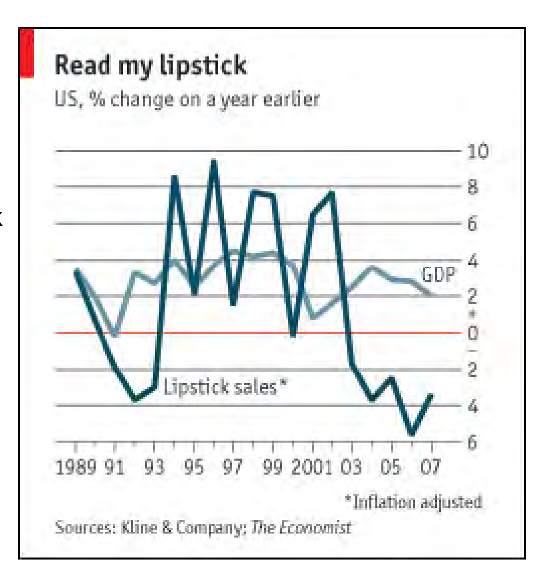
As for L'Oréal itself, its managers would probably not mind being wholly owned by Nestlé, as long as they had operational independence. "We're cousins and we work together already," says one of its employees, "and it would be better than being bought by an Indian or Chinese firm."

Cosmetics in the downturn

Lip reading

Jan 22nd 2009
From The Economist print edition

Do sales of lipstick really go up in difficult times?



RECESSIONS mean that Ferraris stay in showrooms and designer dresses on shop racks, but lipstick bucks the trend: in difficult times, women buy more of it, since it is an affordable indulgence. That, at least, is the idea behind the “lipstick index”, a term coined by Leonard Lauder, the chairman of Estée Lauder, a cosmetics firm, in the 2001 recession. In the gloomy autumn of 2001, lipstick sales in America increased by 11%.

Believers in the lipstick theory trace the phenomenon back to the Depression, when cosmetic sales increased by 25%, despite the convulsing economy. Some, like Dhaval Joshi of RAB Capital, an investment-management firm, point out that employment in the cosmetics industry has been known to rise as overall employment falls, suggesting that demand for cosmetics increases when consumer confidence is low. This was so in the recessions of 1990 and 2001, according to Mr Joshi’s recent report on what he calls the “lipstick effect”.

Not everyone is convinced. Reliable historical figures on lipstick sales are hard to find, and most lipstick believers can only point to isolated, anecdotal examples as evidence of the larger phenomenon. Data collected by Kline & Company, a market-research group, show that lipstick sales sometimes increase during times of economic distress, but have also been known to grow during periods of prosperity (see chart). In other words, there is no clear correlation.

Lipstick sales are merely the latest example of a single measure that has been seized upon because it supposedly reflects economic confidence, or lack of it. Hemlines, alcohol consumption, laxative sales and even who wins the Super Bowl have all been proposed as ways to chart recessions, with varying degrees of success. So is the lipstick index dead?

Karen Grant of the NPD Group, a market-research firm, suggests that it might make more sense to look at a wider “beauty index”, rather than lipstick alone, because she thinks it is beauty as a category that holds up well in recessions, whereas sub-categories (such as lipstick) tend to go in and out of style. Most women would sooner give up silk scarves or designer shoes than mascara or eye shadow, which they consider to be more essential. Men’s spending habits may follow a similar pattern, as they shift from spending on televisions and cars to less expensive luxuries, such as portable gadgets or personal accessories. Watch out: the “cufflink index” could be next.

Face value

The first epistle of St Bill

Jan 23rd 2009
From The Economist print edition

One of the world's richest men gives his inaugural address on the outlook for philanthropy

Times of India



FOR someone who has probably lost more of his own money in the past year than almost anyone in history, Bill Gates is remarkably upbeat. If anything, what he calls the worst economic crisis in his lifetime has made his new life as a full-time philanthropist even more "interesting"—a word he uses in a positive, not an ironic, sense. When he stepped down from Microsoft last summer, his friends feared that he would miss his role at the software giant, and his work at the Bill & Melinda Gates Foundation would seem less engaging and rewarding. But, he says, "I love the work at the foundation." He waxes lyrical about the "magical elements" of working there—so much so that he has decided to write an annual letter to tell the world what he is up to.

It is not his intention, at least in this first letter, to urge his fellow tycoons to give more by penning an updated version of the "Gospel of Wealth" written 120 years ago by Andrew Carnegie, a steel magnate. Compared with Carnegie's fierce lines, such as "the man who dies thus rich dies disgraced," Mr Gates's comment that "I am impressed by individuals who continue to give generously even in these difficult times. I believe that the wealthy have a responsibility to invest in addressing inequality," seems too timid by half. It lacks the hard, unflinching edge that he can bring to his conversations. (Indeed, some senior executives at his foundation say they wish Mr Gates would bring more of that inquisitorial manner to his conversations with them. At Microsoft there would sometimes be heated disagreements, but at least the firm got the benefit of the "real Bill", whereas so far at the foundation he is perhaps being too nice.)

The idea for the letter came from his old friend and philanthropic partner Warren Buffett, boss of Berkshire Hathaway, whose annual letter to his shareholders is a highlight of the business calendar. Whether letters from Mr Gates will come to be awaited as keenly as missives from the "Sage of Omaha" remains to be seen. If they do, it will not be for the jokes. In the first paragraph of his first epistle, which will be released on January 26th, Mr Gates says he will not try to match Mr Buffett's famously folksy humour: "I won't be quoting Mae West."

Stylistic quibbles aside, the letter is worth reading, both for its progress report on the ambitious projects being pursued by his foundation, and for Mr Gates's insights into the economic crisis, which he expects to continue for several years. American consumers, in particular, had been spending far too much, which means restoring markets to equilibrium will be painful and prolonged. And clever people who failed to anticipate the degree to which, once things got negative, they would "get super negative", now feel foolish and will take time to regain their confidence.

Despite the fact that his foundation's assets have declined by over 20% in the past year—actually a decent performance, relative to other institutional investors—Mr Gates is remarkably optimistic. He will be attending the World Economic Forum in Davos, where there will be much talk of the need to "reboot" the global economic system, but he thinks such talk is exaggerated, because the foundations of the economy are basically sound. "Even if it now drops 5-6%, the world economy has delivered phenomenally," he says, predicting that innovation and wealth creation will eventually resume because the underlying market and technological forces remain as potent as before. Well, let's hope so.

His foundation's assets may be shrinking, but it is increasing its giving in 2009, from $3.3 billion last year to $3.8 billion—the biggest ever annual budget for a charitable foundation. Much of this will go towards finding ways to reduce deaths from the 20 diseases that kill the most people in poor countries. Mr Gates has high hopes that the number of children who die each year can be cut by half, to 5m, within 20 years, just as it was cut by half in the past half-century. Polio will soon be eradicated, he believes, and deaths from malaria can fall by half by 2015. And the foundation is increasingly focusing on how to ensure that poor people who enjoy better health also have the income and work necessary for a decent life. Meanwhile, at home, Mr Gates says he is making progress on improving the school system, largely thanks to the success of independent charter schools—although he regards his goal of ensuring that 80% of students leave school ready to attend college as "probably more difficult to achieve than anything else the foundation works on."

Bill payments

Mr Gates promises that his annual letters will be candid and self-critical, which should provide some comfort for those who criticise his foundation for being unaccountable. He admits to having made mistakes early on in his education reforms. He says the foundation is increasingly focused on ensuring that drugs developed for the poor are actually used by them, which should reassure those who think he regards technological innovation (ie, merely developing drugs) as a "magic bullet".

Yet as well as being candid about himself, Mr Gates should in future be more candid about the performance of others without whom his philanthropy cannot succeed, especially politicians. In the first letter, he points only one finger—at the Italian government, led by Silvio Berlusconi, which is reneging on its promised development aid—while giving other governments the benefit of the doubt that they will honour their promises. Similarly, he says he is optimistic that Barack Obama's administration will make progress on school reform, pointing to the extra spending on schools contained in Mr Obama's economic stimulus package and the fact that the new education secretary, Arne Duncan, welcomed Gates-funded charter schools in Chicago. If, say, the Obama administration gives in to hostility to charter schools from teachers' unions, or other governments backtrack on their aid promises, here's hoping that in future annual letters "nice Bill" will not prevent "real Bill" from saying so.

Award: Jonathan Rosenthal

Jan 22nd 2009
From The Economist print edition

Jonathan Rosenthal, our European finance and business correspondent based in Frankfurt, was named reporter of the year at the Workworld Media Awards.

Global economic imbalances

When a flow becomes a flood

Jan 22nd 2009
From The Economist print edition

The deep causes of the financial crisis lie in global imbalances—mainly, America's huge current-account deficit and China's huge surplus

Illustration by Bill Butcher



ASK people what caused the financial and economic crisis and most are likely to plump for some mix of greed and incompetence. Bank bosses have been castigated for fee-seeking gluttony, reckless lending and failure to heed the risks to their institutions. Regulators have been accused of sleeping on watch. Central bankers once lionised for mastering inflation and the business cycle are feted no longer.

Few among the public would be likely to pin the blame on "global imbalances": the pattern of large, persistent current-account deficits in America and, to a lesser extent, Britain and some other rich economies, matched by surpluses in emerging markets, notably China. The damage done to the financial system by lax controls, rotten incentives and passive regulation is plain. Yet underlying the whole mess was the deeper problem of imbalances. A growing number of policymakers and academics believe that these lay at the root of the financial crisis.

Economists had long feared that America would ruin itself on foreign borrowing. The current account, which measures the balance of investment and saving, has been in the red every year since 1992. Until 1997, the annual saving shortfall was modest but it grew steadily thereafter, reaching a peak of $788 billion, or 6% of GDP, in 2006. America needed to borrow from abroad or to sell assets—shares, bonds, property—to pay for the string of deficits. Deficits need not be ruinous, especially if they finance profitable investment. But economists worried that as America's consumption boom took it deeper into hock, foreigners would become less willing to lend to it. That could lead to an abrupt halt to financing and a plunge in the dollar.

Puzzles and explanations

The deficits reflected a falling saving rate rather than a rising investment rate. To finance this, America was sucking in savings from abroad that could not be relied on for ever. The dollar started to decline gradually from 2002 but the current-account deficit only got bigger. There were other puzzles: long-term interest rates ought to have picked up to reflect the scarcity of American savings and the concern about the dollar. But even when the Federal Reserve started to raise short-term rates from the middle of 2004,

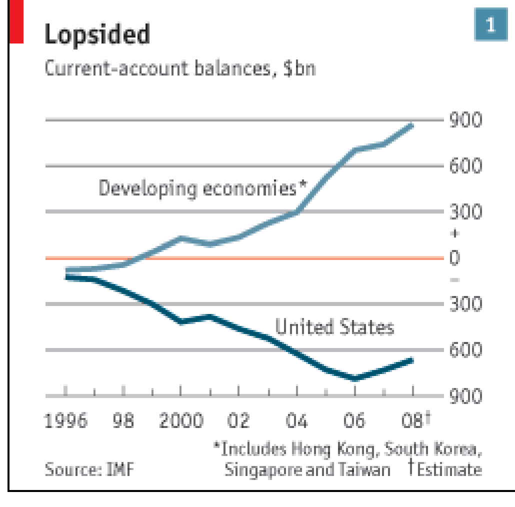
long rates declined. The chairman of the Fed, Alan Greenspan, told Congress in February 2005 that this was a "conundrum".

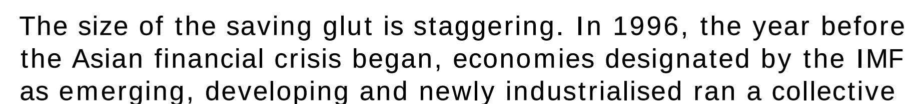
This spurred new thinking on global imbalances, which sought to rationalise why poor countries were so willing to send their savings to rich countries such as America and Britain. Ben Bernanke, now the Fed's chairman, then a governor, argued in 2005 that America's low saving was a passive response to a global "saving glut" washing onto its shores. It was not that America had lapped up foreign capital; rather capital had been thrust upon it. The money flooding in from willing foreign savers had bid up government-bond prices, lowering interest rates and lifting house prices. That encouraged Americans to run down savings and to keep spending.

As academics found fresh theories to explain the saving glut, they became less anxious about the imbalances it produced. The most developed financial markets were found in America, so it was the natural destination for foreign savers seeking safe returns. It could not run deficits for ever but the day of reckoning might be years away. Americans earned far higher returns on their investments abroad than foreigners did on their American assets. That and a weaker dollar helped to slow the increase in foreign indebtedness.

Both the old-school worrywarts and the new-school optimists got some elements of the story right and others wrong. "The dollar crisis that was predicted by the central view is the only one that hasn't happened," says Pierre-Olivier Gourinchas of the University of California, Berkeley. In the depths of the financial crisis in October, the dollar rallied against most currencies. America was not cut off from external funding. But equally there was a crisis—as the pessimists foresaw—and one that has undermined a pillar of the optimists' thinking on imbalances: that America is a beacon of financial stability.

There are signs of a consensus emerging from these two schools. A growing band of economists agree that the forces behind the saving flows from emerging markets are likely to persist. The continuing thirst for dollar assets, albeit of the right sort, suggests that America remains a magnet for global capital. But the belief that its financial system can handle huge saving flows indefinitely has been punctured. Kenneth Rogoff of Harvard University, who had given warning of an eventual reckoning, believes that with $800 billion of net capital flows pouring into the United States in a year, some slippage of regulatory and lending standards was perhaps inevitable. The worry now is that if imbalances are not tackled, they may in time breed another calamity.





The size of the saving glut is staggering. In 1996, the year before the Asian financial crisis began, economies designated by the IMF as emerging, developing and newly industrialised ran a collective current-account deficit of $78 billion. Over the next decade this turned into a surplus of several hundred billion dollars (see chart 1), with China and oil exporters accounting for almost all of the increase in the past three or four years. Much of the turnaround is mirrored in a widening American deficit. (The world's sums do not add up. Statisticians are unable to offset the recent burgeoning surpluses with deficits elsewhere: according to the IMF, in 2007 the surpluses exceeded the deficits by $265 billion.)

The glut and the gap

What persuades developing countries to export capital to the rich world that might be better used at home? Influences on saving vary from region to region. The income of oil-exporting countries, for instance, has ballooned since 2004 because of higher prices for crude. It would have been neither feasible nor wise for oil-rich nations to spend this windfall at home, so much of it was saved and sent abroad. Economists who have looked for something that unifies the saving behaviour of a disparate group of countries, from oil-exporters to metal-bashers, have converged on one important motive: the need to acquire reliable stores of value that can be sold easily when trouble strikes.

This idea has been developed in a series of papers by Ricardo Caballero of the Massachusetts Institute of Technology (MIT), Emmanuel Farhi of Harvard University and Berkeley's Mr Gourinchas. Their thesis is that emerging countries cannot create enough trustworthy saving vehicles to keep up with the pace of

economic growth, because their financial markets are immature. Householders cannot rely on a ready supply of credit—or on government safety nets—so must save hard for a rainy day. But the domestic supply of financial assets is unreliable so the thrifty plump for foreign assets instead. America is the favoured place because it has broad and liquid markets for securities.

That interpretation sits awkwardly with another: that excess saving, particularly in China, is the result of exchange-rate policy. Emerging-market central banks have bought dollars to weaken their own currencies. That encourages exports and depresses spending at home. The result is a high level of net national saving, much of which ends up in central banks' foreign-exchange reserves. These rainy-day funds have swollen since 2004, mostly because of increased hoarding by oil-exporters and by China (see chart 2). How can this reflect private saving?

Mr Gourinchas doubts that depressing the exchange rate could sustain a high rate of saving for long. By flooding the foreign-exchange market with their own money, central banks risk driving up inflation which would erode the gain in competitiveness from a cheap currency. China has avoided that fate because it has been able to "sterilise" its currency interventions by selling bonds to banks, companies and households. That would be an expensive operation, says Mr Gourinchas, were it not for demand for savings. The reserves are collateral for the bonds held privately.



That may be too neat an explanation. In China's tightly controlled financial system, savers have little choice. And firms, not households, account for the recent rise in net national saving. There is another puzzle: why have emerging-market currency reserves grown so large? This was largely a reaction to the painful memory of the Asian crisis: Asian countries wanted to insure themselves against another sudden flight of capital. Reserves need to be large enough to draw upon if foreign-currency financing suddenly dries up, and to ensure that trade flows smoothly. But reserve holdings in some emerging markets have gone way beyond levels suggested by prudential rules of thumb—enough to pay for three months of imports, say, or to cover short-term foreign-currency debt.

Research by Maurice Obstfeld of Berkeley, Alan Taylor of the University of California, Davis, and Jay Shambaugh of Dartmouth College views these "excess" reserves as insurance for the domestic banking system. They argue that in economies with managed exchange rates and fast-growing bank deposits, there is increased risk of a "double drain". When crisis hits, fear of devaluation could spark a rush out of bank deposits into cash, and from cash into hard currency. Reserves are not only a prudent safeguard against a "sudden stop" in foreign finance. They are also needed as insurance against the risk of "sudden flight" by domestic savers.

The authors found that a measure of financial depth—the ratio of broad money to GDP—helped to explain the size of reserves. In a more recent study they found that countries with insufficient reserves to insure their financial systems suffered bigger currency crashes during last year's turmoil. The currencies of countries with full war chests did not depreciate; some rose. If economies draw the lesson that their reserves were not big enough, global imbalances will be even harder to tackle.

Mr Taylor reckons the policy of accumulating reserves accounts for a significant and growing fraction of global surpluses—enough (in the early years of this decade) to finance as much as a third of America's current-account deficit. The self-insurance against financial fragility is part of a more general bent towards precautionary saving in the developing world. If it persists, as seems likely, it will throw the problem of deficient global demand back to America.

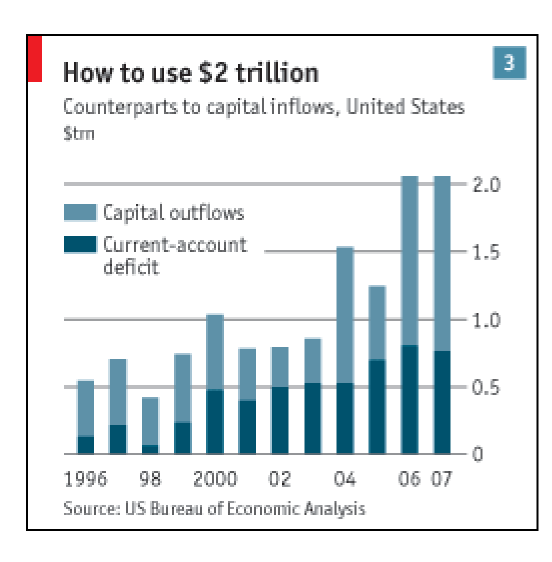
An unsatisfying implication of the literature on the saving glut is that it paints America as a tragic victim of forces beyond its control (though some of the authors insist this is not their belief). The emerging markets' need for insurance, in its many guises, drives them to export capital to America (and to similar places, such as Britain). America, by implication, has no choice but to make room for it.

In fact, Asian savings may have provided the rope; but America hanged itself. The macroeconomic forces that drove the capital flows were hard to reverse. But what made them so devastating was that they were met by microeconomic failures—described in the special report in this issue.

The interaction between the two was fatal. After the dotcom bust, American firms turned cautious and investment spending was weak. That ruled out a natural home for foreign capital. Faced with strong external demand for AAA-rated assets, the financial system got creative. Marginal home loans were packaged into supposedly safe securities. That supply of credit lifted house prices and spurred a boom in residential construction, which filled the gap in demand left by sluggish business investment.

As these loans turned bad and losses mounted, it became clear that banks had set aside too little capital to protect themselves against unexpected losses. That left the banks crippled and the economy on its knees. The villains in this story are the banks for making silly loans and regulators for not insisting on more precautions. But what would a well-regulated financial system have done with the money?

The bait for capital inflows is that America provides reliable and liquid assets, which cannot be found at home. Ideally its financial system might have provided an intermediary service—funnelling emerging-market savings into emerging-market projects. That would have lowered deficits in America and surpluses abroad. Only a fraction of the capital that flows into America is swallowed by the current-account deficit. Much of it finances capital outflows—the purchase of foreign assets by American residents (see chart 3).



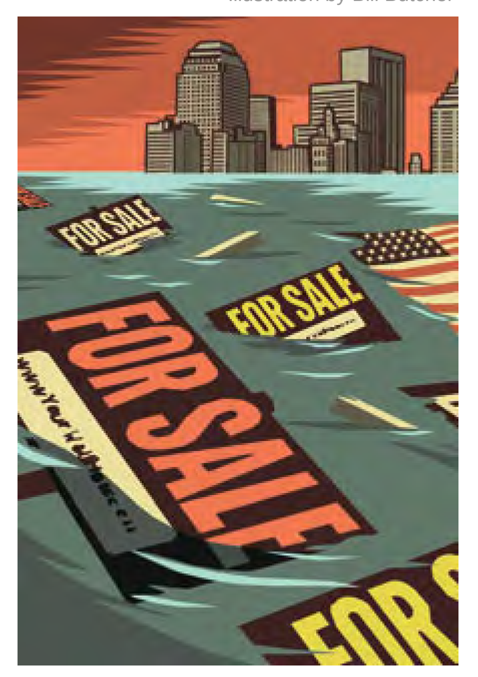
In a world of perfect regulation, the likely outcome would be fewer new assets, such as securities backed by subprime mortgages, and higher prices (and lower returns) on the best assets. That implies long-term interest rates would have dropped even further. That might have given more life to business investment but it might also have fuelled a bigger housing boom, at least in prime real-estate.

Could macroeconomic policy have better addressed the global imbalances? One option would have been to keep an eye on the current-account balance when setting monetary and fiscal policy. Tighter policy might then have dampened consumer spending and curbed imports.

The trouble is that the much tighter policy needed to make a meaningful dent in the trade deficit would have led to recession in America and perhaps in emerging markets too. It would have been hard to justify with inflation so low (and it would also rule out low interest rates and fiscal stimulus now). Mr Caballero at MIT, for one, is sceptical: “I know from my experience in emerging markets that it is very hard to fight capital when it is flooding in. Policy mistakes may have been made at the margin but no more than that.” Yet America’s loose monetary policy after the dotcom bust does bear some blame. After all, a lot of subprime mortgages with variable interest rates were originated when the federal funds rate was very low.

An alternative would be to try to tackle imbalances from all sides. That would require co-ordinated action by surplus and deficit countries. Such attempts failed in the past because everyone had something to gain from sticking with the status quo. China might think Americans should save more but only as long as that did not curb their spending on Chinese imports. America would ask China to revalue its currency and boost its domestic demand. But it was also keen for China to keep buying its public debt.

Illustration by Bill Butcher



Policymakers blithely assumed they would avoid a dollar crisis and that America would export its way out of any trouble. And that was how things were starting to play out before a quite different crisis, in the financial system, blew up.

With luck and good judgment some of the worst excesses of the financial system will now be reined in. The danger is that by focusing on regulatory reform and less clumsy ways to deal with bank failures, policymakers fail to tackle the underlying causes of the crisis. The anxieties that prompt emerging markets to run big current-account surpluses have not been assuaged. Indeed, the crisis may have spurred some countries to seek even more self-insurance in reserves

and other forms of prudential saving.

It’s good to talk

Earnest editorials often call for international talking shops to co-ordinate global demand. Alas, Sino-American exchanges on international economic affairs are often heated: when America’s treasury secretary, Hank Paulson, said recently that imbalances played a role in the run-up to the crisis, he provoked an outcry in China. Past failures of co-ordination initiatives do not offer much hope either. Yet as Raghuram Rajan of Chicago University’s Booth School of Business points out, the crisis has lasted a long time and there is no end in sight: so the situation may soon be ripe for a cooler exchange between surplus and deficit countries. The two big surplus countries in the rich world, Germany and Japan, are suffering deep recessions, which may bring them to the table. The problem of imbalances goes much wider than America and China.

One necessary task is to assure emerging-market countries that they will not be caught out if they run short of liquidity. The IMF might have to be prepared to offer funds more quickly and with fewer strings. Another option would be for emerging markets themselves to pool reserves. The politics of that would be messy at best. As Hélène Rey of London Business School points out, the devaluations within Europe’s exchange-rate mechanism in the early 1990s showed that risk-sharing is far from perfect even where countries have well-established political ties.

The IMF’s resources are puny in comparison with the amounts in the vaults of emerging-market central banks. That is why the swap lines offered by the Fed to four emerging economies in October were a welcome innovation (even if the recipients were flush with their own reserves). But countries will not be persuaded to stop accumulating reserves unless such credit lines can be relied upon in future. The Fed cannot be asked to vet potential recipients: that may be a job for the fund.

America, Britain and other deficit countries have drowned themselves in cheap credit from abroad. Because the structural forces behind the global saving glut are unlikely to abate quickly, there is a real risk that the dangerous imbalances will persist—with America’s public sector as the new consumer of last resort. It would be foolish to focus on fixing the financial industry only to find that the public finances are left in ruins.



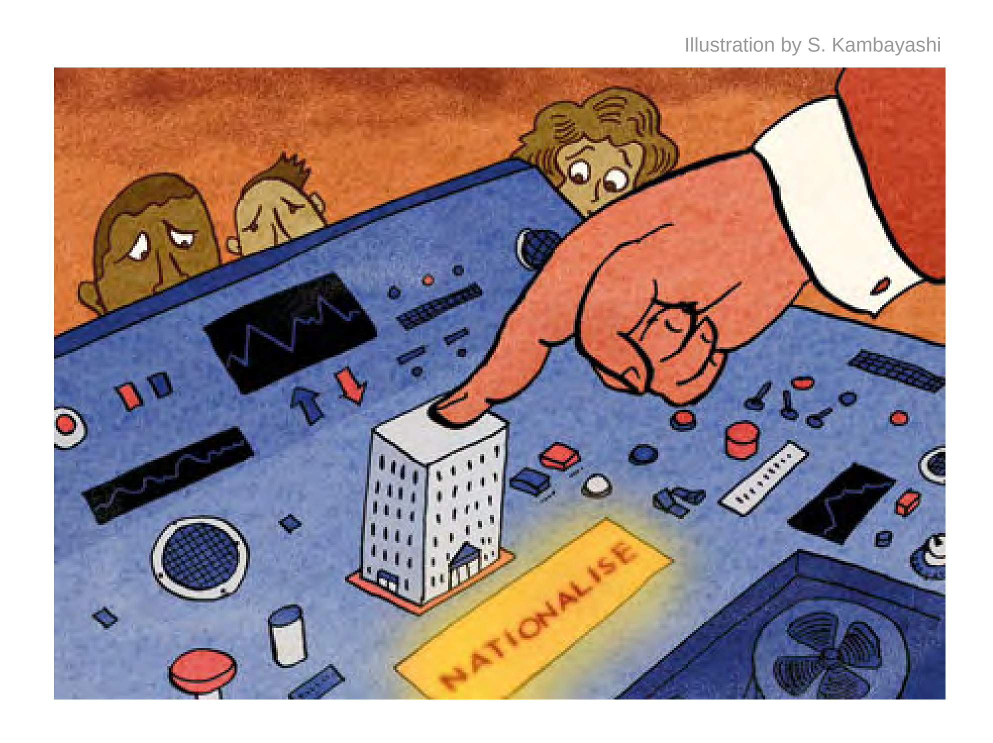
Global banks

Another fine mess

Jan 22nd 2009
From The Economist print edition

Fear of the unknown stalks the banking sector

Illustration by S. Kambayashi



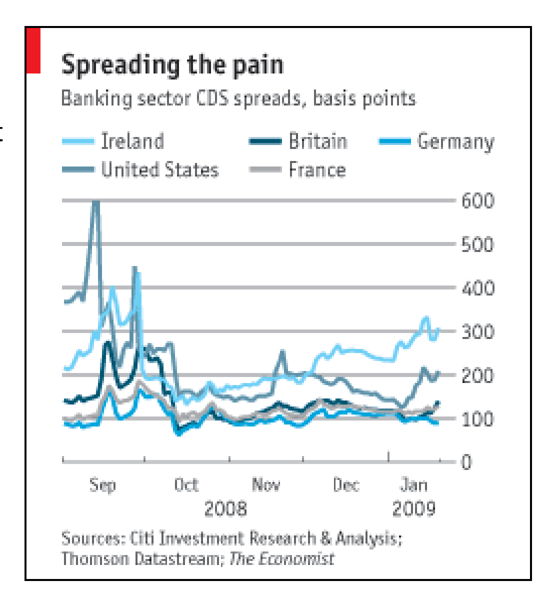
SOME blame the financial crisis on a misalignment of interests between banks' executives, focused on short-term gains, and their longer-sighted shareholders. The problem now is that the goals of owners and managers are too well aligned. Both want to husband capital and lend carefully. That puts them at odds with everyone else.

How else to explain another week of bail-outs, billion-dollar losses and brutal bank sell-offs? Start with the bail-outs. On January 15th the Irish government announced the full nationalisation of Anglo Irish Bank, the country's third-largest lender. Four days later the British government unveiled a potpourri of measures to stimulate lending, including a guarantee scheme designed to protect banks against losses on bad assets and an increase in its stake in Royal Bank of Scotland (RBS) to 70%. On January 20th the French government agreed to provide another €10.5 billion ($13.6 billion) of capital to its biggest lenders. After its predecessor was forced to pump more money into Bank of America on January 16th, the new American administration is working on fresh plans to immunise banks from the effects of their infected assets (see Economics focus).

This burst of action comes just a few months after governments shored up the banking system with capital injections and sweeping guarantees for depositors and creditors. Despite the howls of protest today, that money was not wasted. The assurance that governments will not let important lenders fail continues to keep the fear of bank runs and bankruptcies at bay. Credit-default-swap spreads on bank debt have remained relatively static (see chart), at least compared with the pounding that their shares have taken since the start of the year. Since the fall of Lehman Brothers, default risk has largely shifted from banks to the governments that back them.

That leaves two puzzles to solve. First, if governments have buttressed confidence in the banks' ability to survive, why the

renewed rush to intervene? Second, if governments continue to demonstrate support for the banks, why aren't shareholders rejoicing? The answer to both questions lies in concerns that not enough credit is flowing. Bankers themselves deny the charge that they are hoarding capital. Jamie Dimon, the boss of JPMorgan Chase, told investors on January 15th that his bank "was making loans all the time". Analysts at Credit Suisse reckon that British banks have increased their balance-sheets since June.



The problem is that even if individual institutions manage to grow their books, there is still a huge gap in financing capacity to fill. Foreign lenders are under pressure to focus on their home markets. On January 16th America's Treasury asked the banks in which it has injected capital to provide monthly reports on their lending: it is safe to assume that officials are more interested in loan growth at home than they are abroad. Corporate-bond markets are much livelier than they were but other non-bank sources of finance, such as the securitisation market, remain stagnant.

Replacing this lost capacity would be hard at the best of times. Right now, it is nigh on impossible. Demand for credit is subdued. Losses are surging as the economic climate worsens. Regions Financial, an American regional bank, reported a record $6.2 billion quarterly loss on January 20th on souring property loans. Structured products still have the capacity to wound. Shares in KBC, a Belgian bank, plummeted on concerns that it would take big write-downs on corporate collateralised-debt obligations. Even staid custody banks are finding unpleasant ways to surprise. Shares in State Street lost nearly 60% of their value on January 20th as it announced large losses on bond investments (although Northern Trust, another custodian, beat expectations a day later).

In the face of these losses, the natural (and logical) inclination of banks is to hold on to capital, not to run it down further by ramping up lending. Hence the renewed efforts by governments to free up banks' balance-sheets. Hence, too, the violent sell-offs in many bank shares—the KBW bank index is down by 40% this year—as investors fear that the price of further intervention is dilution.

Public ownership may be unpalatable to many but it is just as difficult politically for governments to keep injecting money into banks without wiping out their owners. Tactically, too, the approach of injecting capital in the form of preferred shares rather than common equity, has its limits (see article). With share prices so low, any more capital-raising is bound to be dilutive (thereby reinforcing the urge of investors to sell). And the woes of Bank of America since its acquisition of Merrill Lynch is a further warning for private capital to sit on the sidelines, leaving governments to pick up the pieces. It may not be imminent or desirable but the threat of nationalisation is looming ever larger.

Bank capital

Fishy stock

Jan 22nd 2009
From The Economist print edition

Banks need equity, not hybrid capital

IT IS like the difference between cod roe and caviar. The bulk of state investments in banks has been in preferred stock, rather than in the purest form of capital, common shares. The difference may sound small but helps to explain why the first round of Western bank bail-outs in October has needed a follow-up.

Under the original 1988 Basel 1 rules governing bank capital, the bulk of banks' tier-one capital had to be common equity. This can suffer losses without defaulting, need not receive a dividend and does not have to be repaid. But banks were also allowed to include some preferred stock, which sits somewhere between debt and equity. Such hybrid capital suffers losses only once the common equity has been wiped out and typically offers more secure dividends.

Over time the rules have been bent by banks and national regulators. The October bail-outs may mark the final stage of this lapse. The hybrid capital supplied by governments has usually been classified as tier-one, but often lacks the features intended for tier-one capital: that it is permanent, that dividends can be cut without defaulting, and that unpaid dividends do not accumulate. Alastair Ryan, an analyst at UBS, says the rules have become a "smorgasbord" and that "everyone is arbitraging" them.

Preference stock does have real benefits. It offers governments and taxpayers more security and it reassures counterparties, depositors and debt-holders who are higher up the capital structure and who get a bigger buffer between them and losses. But it is not a substitute for common equity. It makes shareholders more geared, raising share-price volatility. And it does not boost the long-term capacity of a bank to absorb losses without defaulting. As a result it does not increase such banks' appetite to lend.

More equity is needed. Britain has now swapped its preference shares in Royal Bank of Scotland into pure equity, taking its stake to 70%. In most other cases such swaps would also imply public ownership. Were America to exchange its $45 billion of preference shares in Citigroup into common stock at current prices, it would own over 70% of the voting capital.

Is there an alternative for governments that are allergic to nationalisation? Germany has issued Commerzbank with hybrid capital that bears losses alongside common stock, but which gets a fixed coupon. Any losses must be recovered before common dividends are resumed. That does avoid nationalisation while creating high-quality capital. But whether taxpayers, who have high exposure to losses but limited scope for gains, are supportive of other such schemes remains to be seen.

Sovereign-wealth funds

From torrent to trickle

Jan 22nd 2009
From The Economist print edition

The flows are neither as big nor as scary as they once seemed

WHATEVER happened to sovereign-wealth funds? Eighteen months ago SWFs were destined to acquire swathes of Western companies for foreign governments, not all of which always passed the smell test. They then had a brief cameo as the saviours of Western banks, piling in where few other investors dared to tread. But lately things have gone quiet. That partly reflects the big losses that many funds are sitting on. But there is also a suspicion that the funds are a little passé; that their importance was as exaggerated as the merits of leveraged buy-outs or originate-to-distribute banking.

It is easy to see why they rose to prominence. As the current-account surpluses of oil exporters and Asian countries were recycled, foreign financial assets controlled by governments soared, reaching about $9.5 trillion in late 2008, according to Alex Patelis, an economist at Merrill Lynch. That is equivalent to roughly 15% of the value of all publicly traded shares and bonds worldwide. A quarter of this is held by SWFs. They take more risk than the central banks that manage foreign-exchange reserves, by investing in shares and even hedge funds and private equity.

Assuming a high oil price and a long global boom, the boldest forecasts suggested that the total amount of foreign assets held by governments could double in under a decade and that the proportion invested through SWFs would rise to over half. It was just about plausible that SWFs could become as influential in stockmarkets as hedge or pension funds.

Like most things financial in the past year, nothing has gone according to plan. The sovereign funds that hold shares have suffered large losses. A recent paper by Brad Setser of the Council on Foreign Relations and Rachel Ziemba of RGE Monitor, a research firm, estimates that Gulf foreign-reserve funds and SWFs (the distinction is often blurry) lost $350 billion last year, or 27% of the value of their assets. That is a similar fall to a typical pension fund. High-profile investments in struggling Western banks have been disastrous.

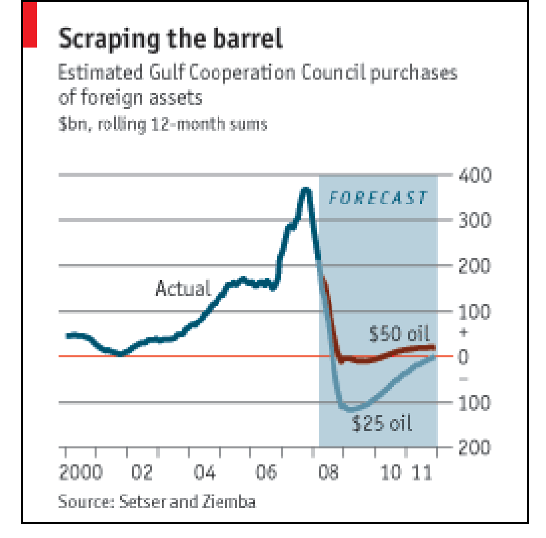
Meanwhile the crisis has shifted priorities. Some countries, such as Russia, have depleted their reserves to defend their currencies from capital outflows. And just as Western governments are borrowing to fund bail-outs and stimulus packages, so many surplus countries are tapping their reserves of extra cash. China Investment Corporation, a $170 billion SWF which invests at home and abroad, has been buying shares in domestic Chinese banks at the same time as Western firms such as UBS, Royal Bank of Scotland and Bank of America have been selling theirs. The $50 billion Qatar Investment Authority has also been buying stakes in local banks to shore them up.

Heavy losses are hardly unique. But the hunger to buy assets may well fade, too. This is easiest to show for oil exporters. Mr Setser and Ms Ziemba estimate that with oil at $50 a barrel (comfortably above its current level), Gulf states' net purchases of foreign assets are likely to be close to zero, from a peak of over $300 billion annually, taking into account likely domestic government spending. With oil at $25, foreign assets would probably have to be sold (see chart). As well as its currency and corporate woes, Russia is expected to face a budget and current-account deficit this year, which may lead it to draw on its surplus cash.

The picture is less clear for Asian countries, which, led by China and Japan, account for about half of the world's foreign-exchange reserves and sovereign-wealth assets. Few expect China's current account to balance even in the medium term, but the country's surpluses are likely to stop growing so quickly and may even shrink before too long.

Even if the SWFs do not become as big as some had projected, might they become more gung-ho, gradually moving out of safe

investments like American Treasury bonds into riskier equities and alternative assets? Here the picture is clear: since the credit crisis began, they have become more risk-averse. Among the most cautious is China, which has been selling American agency bonds since their main issuers, Fannie Mae and Freddie Mac, the two mortgage giants, flirted with default in mid-2008. Instead it is buying Treasuries. The Saudi Arabian Monetary Authority, with $500 billion-odd of assets, is being run even more conservatively than usual: between June and November the share of its funds held in gold, cash and deposits rose from 22% to 31%. The similarly sized Abu Dhabi Investment Authority has been cutting its equity allocation to the lower end of its target band of 40-55% of assets, and giving more to index-trackers and less to expensive active managers.



This caution is not particularly surprising. As Mr Setser puts it, at times of crisis "the only thing you want from your foreign portfolio is not to have to worry about it". Nor is it universal: Singapore has said that its two investment vehicles are now poised to "take advantage" of opportunities thrown up by the slump. But there are good reasons why surplus countries may think hard now before shifting their portfolios into riskier assets.

Stephen Jen of Morgan Stanley points out that the crisis has reminded some economies, such as Russia and South Korea, of how large capital outflows can be; that makes it especially important to buffer reserves with risk-free liquid assets, preferably in dollars, which can be readily used for currency interventions. And it seems likely that large capital inflows contributed to the overvaluation of Western assets. If and when oil exports and trade imbalances next reach a cyclical peak, it may make sense to park surpluses in low-risk assets until the boom subsides.

The China Investment Corporation's website still says it is looking to hire investment professionals who it can offer "exciting" opportunities in a "fast-growing and dynamic institution" that runs "a global portfolio". From being an understatement that now looks like an exaggeration.

Economist.com FINANCE & ECONOMICS

Buttonwood

Beware of Greeks bearing gilts

Jan 22nd 2009
From The Economist print edition

The risks involved in buying government debt

Illustration by S. Kambayashi



CHUCK PRINCE was not the first Citibank executive to put his foot in his mouth. Long before the ex-boss of the big American bank talked about his willingness to "keep dancing" during the credit boom, Walter Wriston, a former CEO, proclaimed, "Countries do not go bankrupt." Not long afterwards, Citibank fell victim to the third-world debt crisis.

In fact, governments have made a habit of stiffing foreign creditors. King Edward III of England was an early example, repudiating his debt to Florentine bankers back in 1339. The Russian revolutionary government repudiated tsarist debt at great cost to French investors, and South American countries are serial defaulters—Ecuador being the latest example.

But now the attention has switched from the developing to the developed world, and in particular the euro zone. Greece, Spain and Portugal have already suffered debt downgrades by the rating agencies; Ireland may follow.

The recession and, in particular, the financial crisis are at the heart of this reversal of fortunes. Bank bail-out packages involve the transfer of risk from the private sector to the public sector. This makes sense in the short term; the appetite for government debt is vast, and expands at times of financial crisis. Governments have the luxury of repaying their obligations over the long term and have shown they can recover from huge debts incurred at times of war. In addition, because of their ability to create money, governments can always repay debt denominated in their own currency, albeit at the risk of inflation. That is why such debt is regarded as risk-free (or in Britain, gilt-edged), although only inflation-linked bonds may merit that description.

Debt incurred in a foreign currency is another matter. Countries that run persistent current-account deficits eventually reach a crisis. The time-honoured answer is to devalue, or depreciate, the currency so that exports can become more competitive and the deficit can be closed. (Britain appears to be following this route at the moment, willingly or not.)

For foreign creditors, such a devaluation represents a partial default (just as for domestic creditors of conventional bonds, inflation is a creeping default). Bond investors thus took delight at the creation of the euro; eliminating the threat of devaluation meant they were willing to buy the debt of smaller euro-zone countries at much lower yields than before.

All that has changed in the past 12 months. Greece is now paying 5.6% for ten-year debt, two-and-a-half percentage points more than Germany and four-tenths of a point more than Poland, which is not even in the euro zone. Greek government debt is set to pass 100% of GDP this year, according to Deutsche Bank; only Italy among euro members has a higher ratio. The position is deteriorating alarmingly; Austria, Greece, Ireland and Spain are all expected to see their debt-to-GDP ratios rise by ten percentage points this year.

Such countries now face a vicious circle; higher financing costs weigh on economic activity, increasing both the size of the deficit and the cost of financing it. Devaluation is not an option; leaving the euro would be incredibly disruptive and would push up financing costs even further. Nor can euro members inflate the cost of the debt away, since they do not control monetary policy.

The only real alternative is a long, hard slog. Public-sector debt can be eroded by running surpluses—in other words, higher taxes or lower public spending. The country's external competitiveness can be improved by holding real wage growth below that of other trading countries. Neither is exactly a vote-

winner.

Meanwhile, the cost of guaranteeing bank debts may be huge. In the case of Ireland, the debts have been estimated at 230% of GDP. Iceland has already shown that a banking system may overwhelm the resources of the country that stands behind it.

It is still hard to imagine a euro-zone member defaulting. Even after the Spanish downgrade, the country's debt is rated AA+, a level most companies would covet. There is a long way to go before a euro-zone country hits junk-bond status.

And whatever the rules say, the EU would surely find a way to rescue a small country within the euro zone, as the potential contagion after a default would be so severe.

Nevertheless, the widening in sovereign-bond spreads in recent months is justifiable. The trend in government finances is dire and although weak countries may be rescued in the end, there will be crises and uncertainty along the way. Even without going bankrupt, countries can torment their creditors.

Japan

Early in, early out

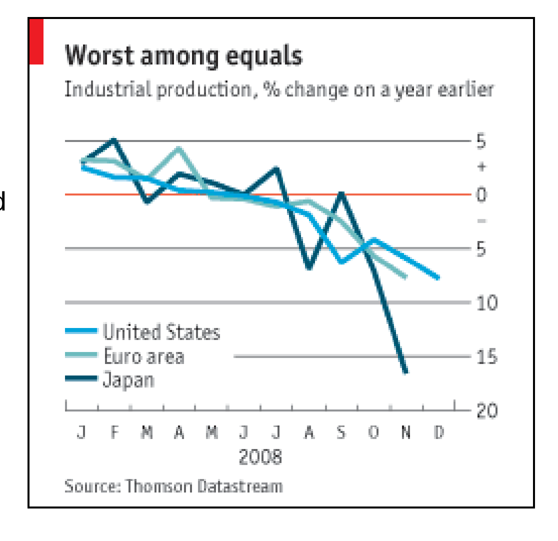
Jan 22nd 2009 | TOKYO
From The Economist print edition

An economy not hit directly by the financial storm is shrinking much faster than any other developed one

NO EVENT is seared upon Japan's recent memory like the bursting of the country's credit-inflated bubble in land and share prices after 1990. Yet, since the autumn, the speed with which Japan's industrial output and exports have fallen almost certainly signals a slump of unprecedented severity, making Japan's several post-bubble recessions look mild. In 1998, the worst year, the economy shrank by 2%. Most economists think it contracted by more than that in the last three months of 2008 alone. Goldman Sachs expects GDP to fall by 3.8% this year.

After six years of growth, the longest uninterrupted post-war run, Japan entered a new recession as early as the second quarter of 2008. But in the final couple of months of the year, what at first was a fairly gentle decline morphed into something far worse than that experienced even by countries at the centre of the credit storm (see chart).

In November the value of exports fell by 27% year on year. The picture only worsened in December with a year-on-year fall of 35%. Recession in the United States was the main cause, with exports there down by 36.9% from a year earlier. In turn, the global slump has also knocked supply chains in Asia, sending Japan's exports to China down by 35.5% in December, with exports to Asia's "tigers" (Hong Kong, Singapore, South Korea and Taiwan) falling by even more than those to America.



Exports account for almost half of Japan's manufacturing output, which as a consequence is seeing its biggest falls since records began: November's output was down by 13% on a year earlier. Orders for machine tools in December, an early indicator of things to come, were 72% lower than a year before. Hiroshi Shiraishi of BNP Paribas reckons that by December industrial output had already fallen back to its post-bubble low in 2001, wiping out the gains from six years of what had been thought to be a solid recovery. Before the slump is over, Mr Shiraishi expects production to slide back to levels last seen in 1987.

It has not helped that the export demand that drove Japan's economic recovery after 2002 was narrowly based on cars and consumer technology, industries that have fallen more than most. Carmakers, for instance, are roughly halving production, with consequences for makers of steel, chips and chemicals.

Perhaps the most unexpected element of the slump is the knock that domestic sentiment is taking. After all, Japan had none of the credit excesses of America and much of Europe: rather than borrow in recent years, Japan's companies have paid off debts, while households sit on a pile of savings. The financial system is largely untainted by toxic securities and bad debts, and though the regional banks look set to start asking for public funds, the big city banks are some way from needing to do that. Still, consumer demand, never strong during the six-year recovery, has weakened fast. Year-on-year car sales are down by more than a fifth; department-store sales have fallen by nearly a tenth. On January 20th the Cabinet Office released its consumer-confidence survey for December, which marked its third consecutive all-time low. The survey points to how badly the slump has spread to services.

Reuters



The inducements aren't working

To cap it all, Japan now faces the return of a ghost it thought it had banished: deflation. By the summer, prices will be falling again. To the extent that this marks a decline in energy prices since last year, it is helpful. But another persistent fall in prices would be a sign of policy failure. In December the Bank of Japan was forced to cut interest rates almost to zero, ie, back to where they last were in 2006. On January 22nd it announced expanded plans to buy commercial paper and even corporate bonds. Takatoshi Ito of Tokyo University, until recently a government adviser, thinks the bank should be doing much more, including making a clear commitment to targeting a positive rate of inflation.

There is cause to temper the pessimism. Households still have their savings. And bank lending to companies is on the rise, though a good chunk of this is taking over from credit once supplied by capital markets, which have dried up.

Crucially, adjustments are happening swiftly in areas that beleaguered companies tackled only slowly during the last slump, such as bloated workforces and excessive capacity. Bankruptcies of "zombie" companies long kept alive on cheap credit and an undervalued currency have soared now that credit is harder to get and the yen has risen to a fairer valuation on a trade-weighted basis. And at the end of a decade in which much more use was made of contract and temporary workers, companies are now laying these off fast. In order to reduce inventories, production is also being slashed. This marks a new flexibility in Japan's economy.

Unemployment, now 3.9%, may head back towards the post-bubble high of 5.5%. At the same time, the structure of the labour force may lessen the pain. As the economy recovered, many companies asked workers from Japan's huge generation of baby-boomers to stay on past retirement age. Plenty of these will now simply retire with their pensions. Swift adjustments to workforces and inventories mean that Japan may recover sooner than other rich economies.

But when, and how robust, that recovery will be is another matter. However fast companies are cutting capacity that once served Americans' debt-fuelled consumption, Japan's whole economic structure is geared towards meeting external demand. That post-war model in Japan is now bust. So too is the political system that built and guided it: after half a century of almost unbroken power, the Liberal Democratic Party, having lost its purpose, is threatened with annihilation at the polls in the next few months.

Ageing population, decrepit politics

Political dysfunction has now become perhaps the biggest issue for the economy. Policymakers should be debating how to foster domestic demand in an ageing and shrinking society—for instance, by dismantling regulations in health care and services for the old that benefit producers over users. Instead, the government is locked in a sterile fight, within its own ranks as well as with the opposition, over a relatively small stimulus worth ¥2 trillion ($22 billion), much of which will be pocketed by consumers, not spent. Masaaki Kanno of JPMorgan Securities thinks that a stimulus four times bigger, designed to raise productivity, is needed to counter the slump in demand.

The government's timidity is encouraged in part by a national debt that soared during the post-bubble years: the ratio of net debt to GDP stands at over 90%. Yet interest rates and so the cost of servicing the debt remain very low; and almost all the debt-holders are Japanese, not flighty foreigners. The risks lie in favour of more vigorous action.

The same applies to the central bank, whose natural caution is reinforced by the absence of political direction or debate. For instance, a case might be made for the Bank of Japan, as well as clearly targeting inflation, to buy equities, so boosting commercial banks' capital, a big part of which is made up of

shareholdings whose value continued to lurch down this week. So here is the irony: whereas the rest of the rich world, starting with America, desperately seeks to avoid Japan’s experience in the post-bubble years, Japan today is condemned by its own dismal politics to drag along behind everyone else.



FINANCE & ECONOMICS

Depreciating currencies

The money-go-round

Jan 22nd 2009 | MUNICH
From The Economist print edition

Will old-fashioned scrip make a comeback?

IN 1933, in the depths of the Depression, Irving Fisher, America's most prominent economist, wrote a pamphlet on "Stamp Scrip". This was a type of alternative currency popular in America and elsewhere at the time that was periodically taxed with a stamp so that it would be spent, not hoarded.

Based on the theories of Silvio Gesell, a German "quasi-economist", one such currency, the wära, was used to revitalise Schwanenkirchen, a Bavarian coalmining village, in 1931. "No one who received wära wished to hold [them], the workers, store-keepers, wholesalers and manufacturers all strove to get rid of them as quickly as possible, for any person who held [them] was obliged to pay the tax. So wära kept on circulating, a large part of [them] returning to the coal mine, where [they] provided work, profits and better conditions for the entire community," Fisher wrote approvingly.

"The miracle of Schwanenkirchen" is a historical footnote, but as deflation fears increase, and interest rates fall close to zero, the allure of such currencies may resurface. Though there are alternative currencies everywhere, Germany is particularly fond of Gesellian depreciating varieties. Bavaria still boasts the biggest in the country, the chiemgauer.

Named after the region where it originated in 2003, the chiemgauer can be used alongside the euro in more than 600 shops and firms in the area. About 300,000 of them are said to be in circulation. In the town of Traunstein, the chiemgauer can be spent on newspapers and food and some people are paid in it.

Spent it must be, because it loses value every quarter. The notes have an expiry date after which they need to be renewed with a sticker costing 2% of their value. The quicker money is spent, the faster, in macroeconomic terms, its velocity. Gesell argued that a higher velocity of money helps combat deflation.

Some of Gesell's theories were rejected by Fisher. But generations later, zero interest rates in slumping Japan led to renewed debate about a temporary tax on money to encourage spending.

Gerhard Rösl, professor of economics at the University of Applied Sciences in Regensburg, who wrote on alternative currencies in 2006 for the Bundesbank, says the overall stimulus from such schemes in times of deflation may be short-lived—because, though the velocity of money increases, its supply tends to shrink. For now, the amounts in circulation are minuscule. Most are a gesture of defiance against globalisation by encouraging local commerce rather than a rigorous economic experiment. But there may be more converts if monetary policy eventually runs out of road.

Economics focus

The spectre of nationalisation

Jan 22nd 2009
From The Economist print edition

There are ways for governments to revitalise banks without taking them over

Illustration by Jac Depczyk



IT IS generally easier to remove a kidney from a dead donor than a live one. When regulators in Scandinavia and America in the early 1990s started extracting the bad assets from their crisis-hit banking systems, it helped that the banks they dealt with were bust or in the government's hands. Today, policymakers are trying to excise toxic assets from banks that are still, at least officially, private and viable. That is a much trickier proposition.

Last autumn, governments around the world poured new capital into private banks and guaranteed their debts to protect them from further losses and help them raise private capital. But continued losses have overwhelmed those initial efforts. Some banks have needed more capital, and a few have been nationalised outright. Moreover, the haphazard implementation of rescues has kept private capital on the sidelines, fearful of being diluted or wiped out. What is needed, the experts say, is a more systematic approach through the creation of a "bad bank" to assume the bad assets, leaving "good banks" to resume lending. (In an Orwellian attempt to hide the nastiness, it may be known in America as an "aggregator bank".)

The good bank/bad bank terminology dates at least back to 1988 when America's Mellon Bank spun off its bad energy and property loans into Grant Street National Bank, which was financed with junk bonds and private equity. Such purely private solutions are not feasible during crises that encompass the entire banking system: there is not enough private capital around. In the early 1990s the governments of Sweden and Finland each nationalised some of their largest banks and set up "bad banks" to dispose of their assets. Around the same time, America created the Resolution Trust Corporation to sell off the loans and underlying collateral of hundreds of failed savings banks, or thrifts. In each case, the assets taken over by the bad bank were equal to about 8% of GDP, according to a study by Daniela Klingebiel of the World Bank.

In this crisis policymakers have adopted piecemeal elements of the good bank/bad bank. In October UBS spun $60 billion of toxic assets into a fund backed by the Swiss central bank. America will absorb most of the losses on $306 billion of problem assets at Citigroup and $118 billion at Bank of America. It is also creating a facility, supported by the Federal Reserve, for asset-backed securities which could relieve banks of bad loans. Britain may insure banks against future losses. Like a bad bank, the aim is to isolate toxic assets, encourage private money to come in and discourage banks from hoarding their capital. But no

market value has been put on them (although loss-sharing agreements in part serve that purpose). This spares banks from immediately recognising their losses, but it leaves a fog of uncertainty over the system. Banks will not boost lending if they fear that future loan losses will eat through the rest of their capital.

A bad bank could alleviate these concerns by convincing both banks and investors that the problem assets have either been removed from the banking system or will be as they surface. Paul Miller of Friedman Billings Ramsey, an investment bank, says a government bad bank can pay more for assets than a private investor because its cost of funds is irrelevant, it needs no capital and can hold the assets to maturity. It could also develop a professional and uniform approach to valuing and disposing of bad assets while leaving new lending decisions to the good banks.

But a bad bank faces different problems, the most serious of which is setting a price for assets that both it and the seller can agree on. This was less of an issue in the early 1990s, since the assets for the most part came from banks that had already failed or were under government control. Today, if the bad bank pays above the fair-market value, it would raise the cost to taxpayers, imperil its political legitimacy, and deprive the market of badly needed transparency. If it pays fair value or less, banks might be reluctant to participate. Those that did may have to recognise large, immediate losses, depleting their capital. As a result, setting up a bad bank would entail additional capital injections. To reassure itself that the recipient bank can survive, the government would invest only if the bank can simultaneously raise funds from private investors. Any bank unable to raise private capital, perhaps rendering it insolvent, would be taken over.

But such steps would be time-consuming and could be hit by a loss of market confidence at any moment. America abandoned its original plan to buy toxic assets last October in favour of extra capital because the crisis demanded faster action.

The nuclear option

An alternative (or perhaps prelude) to a bad bank would be nationalisation. This would at a stroke end the tension between the goals of private shareholders who want to hoard capital and lend less, and government overseers who want banks to lend more and modify mortgages of homeowners facing foreclosure.

But nationalisation carries huge costs of its own. With the world awash in unwanted bank assets, it could take years for the governments to privatise their banks. Meanwhile politicians would be tempted to turn banks into instruments of industrial policy, propping up politically powerful industries such as carmakers and scrimping on more deserving recipients. Politically motivated lending could result in even larger loan losses in the future, and private banks would be put at a disadvantage. At the other extreme, governments might be so fearful of taxpayer losses that they lend even less than their private counterparts.

Economists have long recognised that banks are special. Through decades-old relationships with millions of households and businesses, they normally (though, sadly, not recently) steer savings to productive and lucrative endeavours. Letting banks collapse would wipe out this critical mechanism; nationalising them could, eventually, do it similar damage.

Flexible display screens

Bend me, shape me, anyway you want me

Jan 22nd 2009
From The Economist print edition

Electronic screens as thin as paper are coming soon

Phillip Spears



OVER the years, the screens on laptops, televisions, mobile phones and so on have got sharper, wider and thinner. They are about to get thinner still, but with a new twist. By using flexible components, these screens will also become bendy. Some could even be rolled up and slipped into your pocket like a piece of electronic paper. These thin sheets of plastic will be able to display words and images; a book, perhaps, or a newspaper or a magazine. And now it looks as if they might be mass produced in much the same way as the printed paper they are emulating.

The crucial technological development happened recently at the Flexible Display Centre at Arizona State University. Using a novel lithographic process invented by HP Labs, the research arm of Hewlett-Packard, and an electronic ink produced by E Ink, a company spun out of the Massachusetts Institute of Technology, the centre's researchers succeeded in printing flexible displays onto long rolls of a special plastic film made by DuPont. To make individual screens, the printed film is sliced up into sections rather as folios for magazines or newspapers would be cut from a printed web of paper.

The resulting "electrophoretic" screens are lightweight and consume only a fraction of the power of a typical liquid-crystal display (LCD). Their first use is likely to be by the American army, which helped pay for the project. It hopes its soldiers will be able to use the screens as electronic maps and to receive information. The idea is that the flexible screens will replace some of the bulky devices that soldiers now have to lug around. If that works, the retail market beckons. The first trials of consumer versions could begin within a few years.

Flickering beginnings

Although printing flexible screens in this way will help to make them affordable, they still have a long way to go to catch LCDs. For that, two things need to happen. One is that the displays must turn from black-and-white to colour. The other is that they must be able to refresh their images at a rate fast enough to show moving pictures. Researchers at the Flexible Display Centre and elsewhere are working on ways to do that, and there seems little doubt it will happen. Yet even with their present limitations, flexible screens have some important advantages over LCDs.

For a start, LCDs are difficult and costly to make. Most are produced in huge, ultra-clean factories using batch processes similar to those for making silicon chips. Layers of material which work as filters, electrodes, transistors and the liquid crystal itself are deposited onto a thin glass plate to form a sandwich that is covered with another pane of glass. At each stage the layers are etched to make electrical connections. This is a fractious, finicky process and tiny defects in the materials, or failures in the alignment of the different layers, can result in 20% or more of a batch being scrapped. Moreover, the glass means LCDs are heavy and easily broken, as anyone who has dropped a laptop knows to his cost.

Another drawback is that LCDs consume a lot of power because they are lit from behind. An LCD works because, when an electrical field is applied to the transparent liquid crystals that form each picture element, or "pixel", within the screen, the crystals become opaque. Red, green and blue filters then allow different colours to show within each pixel, but light has to be shone through them for this to happen. That, plus the fact that the liquid crystals will revert to transparency if the power goes off, mean an LCD eats batteries. It also means that the image can be hard to see in bright sunlight.

Electrophoretic displays work in a different way, using a form of electronic ink that has been under development since the 1970s. E Ink's version employs tiny capsules filled with a clear fluid containing positively charged white particles and negatively charged black ones. The capsules are arranged as pixels and electric charges applied to each pixel pull either the black or the white particles towards the top of the capsule (and the opposite colour to the bottom). Unlike an LCD's, this image does not require backlighting. Instead, the user relies on reflected light, as he would if he were reading a sheet of printed paper. Moreover, once the particles in the capsules have settled down they stay put. That means the image remains on the screen without drawing power. A further dose of electricity is required only when the image changes; when a user "turns" to the next page, for example. Not only does this mean that electrophoretic displays are cheaper to run, the lack of constant refreshment makes them more comfortable to read—as comfortable, it is claimed, as printed paper.

Kindling the fire

In fact, electrophoretic displays are already available, but they are built on glass in a similar way to an LCD. One such device is the Kindle, launched by Amazon, an American online retailer, in November 2007. Thanks in part to a ringing endorsement by Oprah Winfrey on her television show, it is now a big hit and prospective purchasers face long delays getting their hands on one. The Kindle, which costs $359, is about the size of a slim paperback (see picture below). It can download books and other publications directly using a built-in wireless connection, and offers electronic editions of some newspapers.

It is not alone, though. Its rivals include Sony's Reader, and a device with a larger screen launched late last year by iRex, a Dutch company. And, later this year, an electrophoretic reader that is built the LCD way, but on plastic, rather than on glass, will also be launched to take them on.

Plastic Logic, the firm that makes this reader, was founded by researchers at the University of Cambridge, has its headquarters in Silicon Valley and does its manufacturing in Germany. The firm uses an adapted version of LCD manufacturing which employs electronic ink and plastic substrates to make its screens. Plastic Logic's prototype reader, which has a screen about the size of a magazine, is a mere 7mm thick and weighs less than 450 grams. It should run for a week in normal use before its battery needs recharging.

Reuters

Plastic Logic says its reader will be aimed at businessmen who might want to store, on a single machine capable of being slipped into their briefcase, all the paper documents and spreadsheets that at present they normally print out. Books and periodicals can be read too. And for those who think they would miss the ability to scribble comments and underline things that paper provides, the reader's screen will be touch-sensitive, allowing such annotations to be made.

Even Plastic Logic's approach, though, is likely to be transitional. If Hewlett-Packard's "self-aligned imprint lithography", as it describes its new technology, can be commercialised, it will take the manufacture of screens through what has proved a crucial transition in every industry in which it has happened—from batch processing to continuous manufacture.

The breakthrough here was to work out a way to simplify the process by

which the electronic circuit that controls the pixels is carved out of layers of conducting, semiconducting and insulating materials. In standard silicon-based electronics, this involves the repeated application of resistive materials to protect those parts of the layer being etched that need to be preserved. Hewlett-Packard’s scientists, however, have worked out how to print a layer of resistive material of variable height on top of all the other layers. After each stage of the etching process a fixed depth of this is dissolved away, exposing a different part of the circuit to the etching chemicals.

The result is a continuous process, much like a printing press. This promises to become a cost-effective mass-production method which Hewlett-Packard will license to other producers, says Prith Banerjee, the company’s research director. Once that happens, he hopes, flexible screens could be used in all sorts of devices.



All the news that’s fit not to print

Colour section

The one feature these screens do not yet offer is colour and, though colour versions will surely come to market, no one is yet sure which version will succeed. Electrophoretic displays can use coloured particles and filters to produce red, green and blue subpixels, but as each colour occupies only one third of a pixel’s area, the brightness of the image is correspondingly reduced. Liquavista, a spin-off from Philips, a big Dutch electronics company, is trying something called “electrowetting”. This uses an electrical field to modify the surface tension of coloured oils and water within pixels that are mounted on a flexible Teflon base. As each pixel is activated, the wetting properties of the oil and water change, making colours visible.

Another approach is to use materials that emit light. Some firms, such as Sony, are looking at organic light-emitting diodes composed of thin films of organic molecules which generate light in response to an electric current. This approach is reckoned to have potential for use in ultra-thin, wall-mounted television sets.

Photonic crystals are a further alternative. These are tiny particles that have a crystal structure which influences the flow of photons, the particles of light. By changing the structure of such a crystal slightly, using an electric charge, the colour of the light reflected by that crystal will change too. Tune the crystals appropriately and you can create different colours.

There are also hybrid methods, like that used by Adrian Geisow at HP Labs’ campus in Bristol, England. He has taken a conventional approach to generating colour, using liquid crystals and red, green and blue filters. However, he has done so in a plastic film produced in a printing-type process. The screen can be backlit, like a standard LCD, but it is capable of retaining its image because the material the liquid crystals sit on encourages the pixels to stay transparent or opaque once they have been switched. However it is eventually done, Dr Geisow is convinced that putting colour into flexible screens is what will turn them into a very big picture indeed.

Epigenetics

Mysterious ways

Jan 22nd 2009 | TORONTO
From The Economist print edition

Evidence for an alternative form of inheritance

JUST how identical are identical twins? That is the question Art Petronis at the Centre for Addiction and Mental Health in Toronto and his colleagues investigate in a paper just published in *Nature Genetics*. The answer is "not as identical as you might think". Moreover, the differences may help to illuminate a process called epigenesis, which allows characteristics to be inherited in a way that is partly independent of the composition of their DNA.

Identical twins are born from a single fertilised egg, or zygote. Genetically speaking, therefore, they are indeed the same. Such "monozygotic" twins have been a boon for researchers who wish to disentangle the effects of "nature" (ie, the genes) from those of "nurture" (ie, the environment), since they can compare them with non-identical—or "dizygotic" twins.

The effects of gestation are neatly set aside in such comparisons, since all co-twins share a uterus. However dizygotic twins share no more DNA than ordinary siblings. So if one monozygotic twin, for example, develops an ailment that the other escapes, the culprit is probably environmental. Conversely, when identical twins prove more likely to share a disease than dizygotic twins, the difference is chalked up to their genes.

It is not, however, enough for organisms to share DNA in order to share characteristics. Those genes must also behave in the same way. One of the ways that the behaviour of genes is regulated is by the application to their DNA of particular clusters of atoms, known as methyl groups. Methylation shuts a gene down. To the extent that the pattern of methylation is passed from parent to offspring, it forms a second, "epigenetic", inheritance mechanism parallel to the primary DNA-based one. The importance of epigenetic inheritance is now a matter of hot debate.

Dr Petronis and his team therefore looked at methylation patterns in DNA from cheek swabs, blood samples and gut biopsies that had been collected from 57 pairs of monozygotic twins. They uncovered a significant amount of variation between twins, possibly enough to explain why apparently heritable diseases that require the coincidence of several genetic risk-factors do not, in practice, always appear in both twins. Schizophrenia, for example, has a family component. But if one twin of a monozygotic pair develops it, there is only a 50% chance that the other will too, rather than the 100% chance that you would see if the sequence of genetic "letters" in the DNA were the only cause.

Dr Petronis then looked at whether the amount of difference between the epigenomes of identical twins was similar to that between non-identicals. He studied samples from 80 pairs of twins, half of whom were non-identical, and, once again, created epigenetic profiles for all of them. The results suggest that although monozygotic twins do differ epigenetically, they differ less than dizygotic twins.

This is all very confusing. The prevailing wisdom about epigenesis is that most existing methylation is erased when the eggs and the sperm are maturing. That should stop epigenetic patterns being passed on, and allow new ones to be imposed to suit the needs of the newly created organism. Indeed, there are several waves of epigenetic reprogramming during an embryo's development.

That some methylation escapes pre-fertilisation erasure has been suggested by experiments on other animals, but this has been thought the exception, rather than the rule. If that were so, though, the degree of difference between identical and non-identical twins would be broadly the same. It is not. Quite a lot of pre-existing methylation is making its way into the new individual—and thus providing both a complication to those who try to understand the intricacies of inheritance, and a promising new line of inquiry.

Epigenetics

Mysterious ways

Jan 22nd 2009 | TORONTO
From The Economist print edition

Evidence for an alternative form of inheritance

JUST how identical are identical twins? That is the question Art Petronis at the Centre for Addiction and Mental Health in Toronto and his colleagues investigate in a paper just published in *Nature Genetics*. The answer is “not as identical as you might think”. Moreover, the differences may help to illuminate a process called epigenesis, which allows characteristics to be inherited in a way that is partly independent of the composition of their DNA.

Identical twins are born from a single fertilised egg, or zygote. Genetically speaking, therefore, they are indeed the same. Such “monozygotic” twins have been a boon for researchers who wish to disentangle the effects of “nature” (ie, the genes) from those of “nurture” (ie, the environment), since they can compare them with non-identical—or “dizygotic” twins.

The effects of gestation are neatly set aside in such comparisons, since all co-twins share a uterus. However dizygotic twins share no more DNA than ordinary siblings. So if one monozygotic twin, for example, develops an ailment that the other escapes, the culprit is probably environmental. Conversely, when identical twins prove more likely to share a disease than dizygotic twins, the difference is chalked up to their genes.

It is not, however, enough for organisms to share DNA in order to share characteristics. Those genes must also behave in the same way. One of the ways that the behaviour of genes is regulated is by the application to their DNA of particular clusters of atoms, known as methyl groups. Methylation shuts a gene down. To the extent that the pattern of methylation is passed from parent to offspring, it forms a second, “epigenetic”, inheritance mechanism parallel to the primary DNA-based one. The importance of epigenetic inheritance is now a matter of hot debate.

Dr Petronis and his team therefore looked at methylation patterns in DNA from cheek swabs, blood samples and gut biopsies that had been collected from 57 pairs of monozygotic twins. They uncovered a significant amount of variation between twins, possibly enough to explain why apparently heritable diseases that require the coincidence of several genetic risk-factors do not, in practice, always appear in both twins. Schizophrenia, for example, has a family component. But if one twin of a monozygotic pair develops it, there is only a 50% chance that the other will too, rather than the 100% chance that you would see if the sequence of genetic “letters” in the DNA were the only cause.

Dr Petronis then looked at whether the amount of difference between the epigenomes of identical twins was similar to that between non-identicals. He studied samples from 80 pairs of twins, half of whom were non-identical, and, once again, created epigenetic profiles for all of them. The results suggest that although monozygotic twins do differ epigenetically, they differ less than dizygotic twins.

This is all very confusing. The prevailing wisdom about epigenesis is that most existing methylation is erased when the eggs and the sperm are maturing. That should stop epigenetic patterns being passed on, and allow new ones to be imposed to suit the needs of the newly created organism. Indeed, there are several waves of epigenetic reprogramming during an embryo’s development.

That some methylation escapes pre-fertilisation erasure has been suggested by experiments on other animals, but this has been thought the exception, rather than the rule. If that were so, though, the degree of difference between identical and non-identical twins would be broadly the same. It is not. Quite a lot of pre-existing methylation is making its way into the new individual—and thus providing both a complication to those who try to understand the intricacies of inheritance, and a promising new line of inquiry.

Correction: Cortisol

Jan 22nd 2009
From The Economist print edition

In last week's article about singing hyraxes ("The song of songs", January 17th), we referred to the animals' cortisone levels as being an indicator of the stress they were experiencing. We actually meant cortisol, a hormone produced in response to stress. Cortisone is a precursor molecule of this hormone that is sometimes used as a medicine. Sorry.

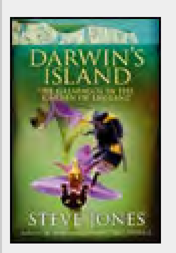
Charles Darwin

A natural selection

Jan 22nd 2009
From The Economist print edition

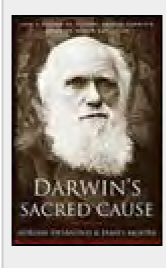
Of the many books marking the 200th anniversary of the birth of the father of modern evolutionary theory, two contrasting volumes stand out

Darwin's Island: The Galapagos in the Garden of England
By Steve Jones



Little, Brown; 320 pages; £20

Darwin's Sacred Cause: How a Hatred of Slavery Shaped Darwin's Views on Human Evolution
By Adrian Desmond and James Moore



Houghton Mifflin Harcourt; 448 pages; $30. Allen Lane; £25

Illustration by Daniel Pudles



CHARLES DARWIN is known to the world for one book. “On the Origin of Species by Means of Natural Selection, or the Preservation of Favoured Races in the Struggle for Life”, to give it its full, long-winded Victorian title, was published a century-and-a-half ago this year. In truth Darwin was a prolific author. Like a 19th-century David Attenborough, he churned out volume after bestselling volume on earthworms, coral reefs, emotion, orchids, barnacles, insectivorous plants and, of course, human origins.

Darwin would probably forgive the avalanche of books celebrating this anniversary and his 200th birthday, even if it leaves the modern reviewer reeling. There is an edited edition of his letters from his trip round the world on HMS *Beagle*, an effort to connect his life with that of Abraham Lincoln (who was born on the same day, February 12th 1809), an attempt (surely redundant for supporters and futile for opponents) to explain “Why Evolution is True”, and even a collection of essays on Alfred Russel Wallace, who came up with the idea of natural selection at the same time as Darwin, and bounced him into publishing before he was really ready. “On the Origin of Species”, too, has been republished, complete with a trendy cover by Damien Hirst, a trendy British artist. But in the search for a new angle to tempt the jaded public, the most successful offerings are those of Steve Jones, a geneticist, and Adrian Desmond and James Moore, two historians of science.

“Darwin’s Island”, Mr Jones’s book, is not, actually, all that much about Darwin. Instead, each chapter uses one of the naturalist’s other books as a point of departure for a meandering, but ultimately enlightening, natural-history lesson. “Insectivorous Plants”, published in 1875, inspires a chapter called “The Green Tyrannosaurs” that shows, using modern genetics, how insectivory has evolved many times in unrelated groups of vegetables in response to a lack of nitrogen in the soil. “The Movements and Habits of Climbing Plants” (also published in 1875) gives rise to an exploration of how similar the problems faced by plants are to those faced by animals, and how the former deal with them without being able to move. The four-volume treatise on barnacles (1851-54), is used to investigate the central question of how species originate. And “The Descent of Man, and Selection in Relation to Sex” (1871) is the point of departure for the inevitable chapter on human evolution.

Mr Desmond and Mr Moore, by contrast, have written very precisely about the man himself. “Darwin’s Sacred Cause” is an exhaustive tome by the authors of an earlier biography, “Darwin” (1992). Their thesis is that, far from arriving at the idea of human evolution from his studies of natural history, Darwin took as one of his starting points the diversification of humanity into “races”.

There are many interesting twists here. That humanity is one and indivisible would have been taken for granted until about the time of Darwin’s birth. Christians, at least, would have believed that everyone was descended from Adam and Eve, with what biologists would now refer to as a genetic “bottleneck” at the time of Noah. By the time Darwin was a student in Edinburgh and Cambridge, though, this was being questioned. The idea that the different races had different origins (from different types of monkey, or from different acts of divine creation, depending on the views of the proposer), began as a convenient piece of slave-traders’ propaganda, intended to denigrate the humanity of Africans. It rapidly became a matter of scientific debate, challenging the literalist interpretation of the Bible in a manner reminiscent of the questioning of the early geologists with their antediluvian fossils.

Darwin, brought up among Whiggish abolitionists and then exposed during his circumnavigation both to the horrors of slavery and to people from almost every one of the races into which Victorian science was dividing mankind, became convinced of the opposite. He saw humanity as the product of common descent. The different races were, in his view, branches of a single tree—or, more accurately, twigs of a single branch, for the tree itself was not just the human family tree, but the tree of life. According to Mr Desmond and Mr Moore, it was the unity he saw in humanity's diversity as much as that visible in the different breeds of domestic animals (fancy pigeons, for example), which helped him understand what was going on.

Reader, beware: this book is as much about the anti-slavery movement as it is about the genesis of a scientific idea. It also, unlike Mr Jones's book, presents itself as a work of scholarship; there are 79 pages of notes and bibliography while "Darwin's Island" has none. But, if nothing else, "Darwin's Sacred Cause" shows that there is still new material to be gleaned from the life of a man much picked over, and who turned the world upside down.

Darwin's Island: The Galapagos in the Garden of England.
By Steve Jones.
Little, Brown; 320 pages; £20

Darwin's Sacred Cause: How a Hatred of Slavery Shaped Darwin's Views on Human Evolution.
By Adrian Desmond and James Moore.
Houghton Mifflin Harcourt; 448 pages; $30. Allen Lane; £25

Central Africa

Bloody history, unhappy future

Jan 22nd 2009
From The Economist print edition

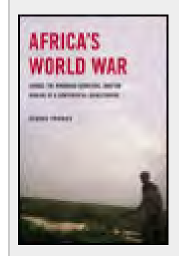
NO ONE doubts the scale of the war in Congo. Ten African countries dispatched troops there in 1998. Two, Uganda and Rwanda, were trying to overthrow their former puppet, President Laurent Kabila, the others ostensibly seeking to prop him up. Although Madeleine Albright, then America's secretary of state, called it Africa's "first world war", the armies did little fighting. The horrific death toll—as many as 5m—was caused, as so often in Africa, by people fleeing their homes and dying of hunger and disease.

And what of the reaction of the rest of the world? The Kosovo war, which occurred at the same time, affected 3m people of whom 10,000 died. Outside powers appealed for $471m to help the victims and NATO eventually sent 30,000 troops to hold the ring. In Congo 86m people were affected. The United Nations asked for $314m. No troops were sent (though the UN now has over 18,000 personnel there). Kosovo is at peace, but the war in eastern Congo, which began in 1993, has never ended.

Most of central Africa was colonised by the French or the Belgians, and René Lemarchand and Gérard Prunier are France's two leading experts. Both have written their latest contributions in English, perhaps because, as Mr Lemarchand puts it at the start of "The Dynamics of Violence in Central Africa", this region "matters". It matters because it is the great core of Africa, its breadth nearly the distance between London and Moscow. It matters because its nine neighbours are all affected by its upheavals and because parts of it are stuffed with valuable minerals. And it matters because the war that engulfs it is brutal, unending and often overlooked.

Both these books are written to disprove fashionable hypotheses about the war and its causes. Mr Prunier, elaborate, anecdotal and discursive, enjoys demolishing the idea that the war is a conspiracy of English-speaking countries to prise Congo away from the French sphere of influence. He points out that despite the intervention of Congo's neighbours in 1998, this was never a world war. In fact the invading armies soon settled down to do business and dig minerals. Rwanda and Uganda suddenly became significant diamond and gold exporters. Mr Lemarchand, tighter, more academic but equally passionate, convincingly argues that, although natural resources may prolong wars, they do not start them. The cause of the war, he says, was social and political exclusion. This is still not being remedied by any of the belligerents—or the foreign donors whose millions enable the local leaders to maintain the state of war.

The Dynamics of Violence in Central Africa
By René Lemarchand



University of Pennsylvania Press; 328 pages; $59.95 and £39

Buy it at
Amazon.com
Amazon.co.uk

Africa's World War: Congo, the Rwandan Genocide, and the Making of a Continental Catastrophe
By Gérard Prunier



Oxford University Press; 529 pages; $27.95

Buy it at
Amazon.com
Amazon.co.uk

Throughout this region the basis of the exclusion is the division between Hutu and Tutsi. Technically the same people—they speak the same language and belong to the same culture—their differences, occupational and physical, were deepened and manipulated by the German and Belgian colonists. After independence, governments in Congo, Rwanda and Burundi, backed by Europe and America, rewrote the histories of these divisions and cynically used them to stay in power.

The current pseudo-democratic regime in Rwanda does not represent a substantial break with the past in this. Backed by Britain and America, President Paul Kagame manipulates the Hutu-Tutsi divide more subtly than his predecessors, but just as fatally. Neither author believes that Rwanda's interventions in eastern Congo can be justified in terms of preventing genocide, particularly since the war there has killed nearly five times the number who were murdered in Rwanda in 1994.

Rather, Mr Prunier points out, the genocide in Rwanda acted as an incendiary bomb, setting fire to

disputes that go back generations. Both these books help disentangle the fiendishly complicated histories of national and tribal identities, real and invented. Neither has a simple answer nor an optimistic view of the future.

Africa's World War: Congo, the Rwandan Genocide, and the Making of a Continental Catastrophe.
By Gérard Prunier.
Oxford University Press; 529 pages; $27.95

The Dynamics of Violence in Central Africa.
By René Lemarchand.
University of Penn- sylvania Press; 328 pages; $59.95 and £39

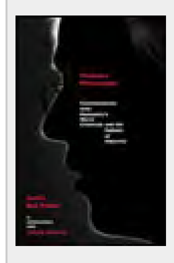
Carla Del Ponte

Madame Prosecutor

Jan 22nd 2009
From The Economist print edition

"THERE is no way to...cushion the disappointment and sense of anticlimax," writes Carla Del Ponte, the former chief prosecutor of the UN's Yugoslav war crimes tribunal, "because the simple fact of failure is the simple fact of failure." These startling words conclude her book about the eight years she spent chasing Balkan war criminals. But perhaps they are not so surprising, after all.

Madame Prosecutor: Confrontations with Humanity's Worst Criminals and the Culture of Impunity
By Carla Del Ponte and Chuck Sudetic



Other Press; 448 pages; $25.95

Buy it at
Amazon.com
Amazon.co.uk

Ms Del Ponte, a Swiss prosecutor, was appointed to the tribunal in The Hague in 1999. Ruthlessly harrying the former Yugoslavs into giving up those that the court had indicted for war crimes including genocide, Ms Del Ponte became the most loathed woman in south-eastern Europe. One of the most enjoyable aspects of this memoir, which was published in Italy last year and is now coming out in English, is to see that loathing so heartily reciprocated. There are no diplomatic niceties here.

After one Bosnian Croat was acquitted of a massacre, Ms Del Ponte's colleagues discovered that crucial evidence had been doctored. The Croats set up a whole team specifically to thwart the tribunal's work. Croatian leaders, she notes, always made bountiful promises before resorting to "stealth and deception and attack from behind". Citing a colleague, she concludes: "The Serbs are bastards... But the Croats are sneaky bastards."

Ms Del Ponte was wise to ask Chuck Sudetic to act as her co-author. A former journalist, Mr Sudetic's book, "Blood and Vengeance", which described the killing of some 7,500 Bosnian Muslims at Srebrenica in 1995, was one of the best on the Bosnian war. His writing gives Ms Del Ponte's memoir crucial historical depth, which is what separates it from the dozens of others written by diplomats and soldiers who have tangled with the Balkans.

In this story there are no heroes and Ms Del Ponte, attacked from all sides, is sometimes on the defensive. In 2007 Bosnia failed to establish in the International Court of Justice that Serbia was directly involved in genocide during the Bosnian war, though it was found guilty of not preventing what the court said was genocidal killing in Srebrenica. Ms Del Ponte was accused of taking delivery of transcripts from Serbia, which many, including her, believe proved Serbia's guilt there, on condition that they were kept out of the hands of the court. She denies this. That Florence Hartmann, Ms Del Ponte's former spokeswoman, is now on trial at the tribunal, accused of contempt of court for writing about the same issue and allegedly revealing its confidential decisions, is clearly absurd and smacks of spite.

Most disturbing is Ms Del Ponte's tale of how her team investigated allegations that in the summer of 1999 up to 300 people were kidnapped with the involvement of men, some very senior, from the Kosovo Liberation Army, a guerrilla group. From Kosovo they were taken to Albania where all were murdered, a small number after their organs had been harvested. The investigation failed to provide enough evidence to form the basis of a case, however. That may not be surprising: one Albanian prosecutor told her team, "If they did bring Serbs over the border from Kosovo and killed them, they did a good thing".

Ms Del Ponte feels she failed because although the vast majority of those indicted were brought to trial, several of the most prominent people managed to walk free. The former Serbian leader, Slobodan Milosevic, died before the end of his trial. The Bosnian Serb leader, Radovan Karadzic, and his military chief, Ratko Mladic, were still at large at the end of her tenure, though Mr Karadzic has since been arrested.

The constant theme of this book is the tension between the demands of justice and the victims and those of political expediency. Ms Del Ponte was, from 1999 to 2003, chief prosecutor of the Rwanda tribunal

based in Tanzania, a job which she also writes about with bitterness. Her failure there, she says, was that she was unable to dispense justice equally. Britain and America protected the Tutsi-dominated, post-genocide government of President Paul Kagame from any serious investigation into whether it had committed crimes too (see article). A depressing, but necessary tale of our times.

Madame Prosecutor: Confrontations with Humanity's Worst Criminals and the Culture of Impunity.
By Carla Del Ponte with Chuck Sudetic.
Other Press; 448 pages; $25.95

Profits and charity

How to be bold

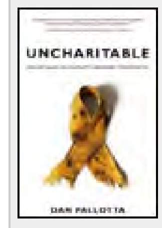
Jan 22nd 2009
From The Economist print edition

BETWEEN 1994 and 2002, more than $300m was raised in America for dozens of AIDS and breast-cancer charities at bike rides and walks organised by a profit-making fund-raising outfit called Pallotta TeamWorks. Then, in August 2002, after many of the charities decided to bite the hand that fed them, the Los Angeles-based organisation was forced to close, sacking its 350 employees. The final straw had been the decision by Avon Products Foundation to launch its own version of a three-day breast-cancer walk developed by Pallotta, which it fired.

Matt Mendelsohn



Uncharitable: How Restraints on Nonprofits Undermine Their Potential
By Dan Pallotta



Tufts University Press; 340 pages; $35

Buy it at
Amazon.com
Amazon.co.uk

The charities had become angry after a number of newspapers complained that the firm was too costly, charging expenses that typically exceeded the 35 cents per dollar raised recommended by various charitable watchdogs. They also complained that Pallotta was a for-profit company, and that its founder, Dan Pallotta, paid himself a salary well above the norm.

As Mr Pallotta points out in his riposte, “Uncharitable”, firing his firm may have got the expense ratio down, but it did the charities no good. After Avon started its own three-day walks, the most it managed to raise was $22.7m after expenses; the last walk organised by Pallotta TeamWorks, after costs, had provided Avon with $70.9m to make grants. The other charities that dispensed with Mr Pallotta’s services suffered similar falls and some had to lay off staff.

Mr Pallotta’s anger at his treatment has prompted a big idea: the charitable sector should embrace capitalism, and not just by borrowing business methods from the corporate world, but by actively seeking to make a profit by doing good. Why is most charity hopelessly ineffective, he asks? Because it is run according to an ideology that ensures it will fail: charities are starved of the money, techniques and talents they need to succeed—things that are taken for granted in the business world.

Mr Pallotta blames the Puritans who founded America, especially John Winthrop, who set out in his famous “city on a hill” sermon that the “Modell of Christian Charity” requires the poor to be given handouts rather than helped to escape from their poverty. “Charity”, argues Mr Pallotta, “is no longer an exchange between the non-needy and the needy. It is an exchange between the non-needy (donors) and the non-needy (the charity work force) to provide services to the needy. It is an exchange between equals to help the needy.” Why is society happy that carmakers make a profit, pay competitive salaries and advertise their goods, yet it is outraged when charities do the same?

Mr Pallotta produces quite a lot of both data and logic. If you do not first analyse a fund-raiser’s results, how is it possible to judge whether what it spent was justified? He also makes a convincing case for charities to spend far more on advertising, perhaps even selling shares to pay for it. If this makes you queasy, read Mr Pallotta’s book. As he says, “To mount a campaign to convert 6 billion people to love—which is essentially the role of charity—takes a lot of money…Raise the capital to promote the idea by offering a return on investment, hire the best people to manage the effort, and run the advertising to spread the word. You beat capitalism at its own game.”

Uncharitable: How Restraints on Nonprofits Undermine Their Potential.
By Dan Pallotta.
Tufts University Press; 340 pages; $35

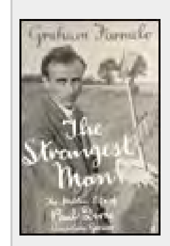
Paul Dirac

Theoretical physics

Jan 22nd 2009
From The Economist print edition

GENIUS is said to have two forms. There are ordinary geniuses, whose achievements one can imagine others might have emulated, so long as they worked extremely hard and had a dollop of luck. Then there are extraordinary geniuses (Mark Kac, a mathematician, called them "magicians") whose insights are so astonishing and run so counter to received wisdom that it is hard to imagine anyone else devising them. Einstein was one such genius. Paul Dirac, whose equations predicted the existence of antimatter and who died in 1984, was another. He was quite probably the best British theoretical physicist since Isaac Newton.

The Strangest Man: The Hidden Life of Paul Dirac, Quantum Genius
By Graham Farmelo



Faber and Faber; 560 pages; £22.50. To be published in America by Basic in October

Dirac became one of the fathers of quantum mechanics at the age of 23. The theory, developed in the 1920s and 1930s, makes seemingly bizarre statements, including the fundamental truth that it is impossible to know everything about the world. But while his colleagues struggled with the philosophical implications of their equations, Dirac thought words were treacherous and saw merit only in mathematics. For him, equations were beautiful. As he aged, he grew more certain that beauty was a guide to truth. His view that fundamental physics could be gleaned from elegant mathematics now permeates a whole field of inquiry into the reality of nature, string theory.

The European academic environment in which quantum mechanics sprouted was torn apart by the political turmoil that led to the second world war. Dirac was a loyal friend to people on all sides of the conflict. He campaigned, unsuccessfully, for the release of Peter Kapitza, a Russian physicist detained by the Soviet authorities. Dirac also remained true to Werner Heisenberg, a German physicist suspected of being a Nazi sympathiser.

Dirac was notoriously reticent. He barely spoke and his silences were legendary. He was unwilling to collaborate with others. He was emotionally withdrawn and appeared bereft of any social sensitivity. To many of his colleagues, he appeared uninterested in anything other than mathematics. They were astonished when he married. Yet he was far more than a desiccated calculating machine, as Graham Farmelo's biography shows. Dirac was a devotee of comic strips and he enjoyed Mickey Mouse films. He later developed an enthusiasm for an American singer, Cher.

Mr Farmelo's sympathetic portrait sketches Dirac's unhappy family background. His parents appear to have loathed one another, and his elder brother committed suicide. Dirac blamed his father for the death. Certainly, some aspects of his father's behaviour warrant criticism. After Dirac won two scholarships to Cambridge, it appeared that he would lose his place for want of £5. Dirac's father gave his son the money and made him understand that he had launched the boy's career. Later Dirac learnt the truth. After his father died in 1936, it emerged that he had not given Dirac the essential £5, although he could have done so, having hoarded more than £7,500, some 15 times his annual salary. The crucial fiver had come from the local education authority.

Dirac went on to win the Nobel prize in physics in 1933 for his discovery of antimatter. Of the small group of young men who developed quantum mechanics and revolutionised physics almost a century ago, he truly stands out. Paul Dirac was a strange man in a strange world. This biography, long overdue, is most welcome.

The Strangest Man: The Hidden Life of Paul Dirac, Quantum Genius.
By Graham Farmelo.
Faber and Faber; 560 pages; £22.50. To be published in America by Basic in October

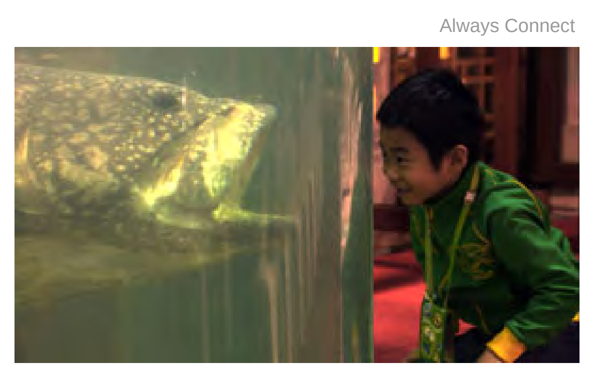
Sundance film festival

Underwater treasures

Jan 22nd 2009
From The Economist print edition

Documentary makers look for the next eco-blockbuster

Always Connect



For better or worse, but not for lunch

IT IS hard to overestimate the impact of “An Inconvenient Truth”, not least on the film industry. Al Gore’s 2006 feature-length admonition on the effects of global warming grossed nearly $50m, making it one of the most successful documentaries after “Fahrenheit 9/11” and “March of the Penguins”. Judging by the films on offer at the Sundance film festival this month, every documentary maker now wants to be the next Mr Gore.

“Eco-documentaries tell the stories of our time,” said Rupert Murray, director of “The End of the Line,” another feature-length film based on a 2004 book by Charles Clover, the environment editor of London’s *Daily Telegraph*. Mr Clover’s research exposes the effects of overfishing on oceans and those who depend on them for food. In a similar vein, “The Cove”, which documents the slaughter of dolphins in Japan, explores how human beings have upset the sea’s ecosystems, putting people at risk as well as marine life. “There is a general feeling that things are changing faster than they ever have, ” says Mr Murray. “Eco-documentaries are a reflection of that.”

“The End of the Line” uses the same lyrical underwater footage as nature documentaries, such as “The Blue Planet”. But rather than lulling the audience into a false sense that all is well in the oceans, it catches the viewer’s attention with meditative camerawork and lush, dramatic music and then reveals the inconvenient truth about the impact of over-fishing on the oceans. The film unfolds like a mystery, with Mr Clover as detective. The film-makers travel to Nova Scotia, the Bahamas, Tokyo and the Mediterranean, as well as to a small village in west Africa whose supply of fish has been halved in recent years as a result of over-fishing. Ignorance, corruption and greed all play a part.

“The Cove” follows Richard O’Barry, who trained the dolphins in “Flipper”, a popular 1960s television show. Ever since, Mr O’Barry has worked to stop dolphins from being captured and sent to amusement parks. In “The Cove” he focuses on trying to prevent the slaughter of 23,000 dolphins a year in a bay off Taiji, Japan. Local fishermen, who believe dolphins are responsible for their shrinking catch, do all they can to thwart Mr O’Barry’s efforts.

For eco-documentary makers it is not enough just to screen films in cinemas. Both these films also put out a call to action. As Robert Redford, founder of the Sundance festival, says: “Just explaining the problem isn’t enough. You have to show what people can do about the problem.” At its conclusion, “The End of the Line” offers suggestions for helping to stop overfishing: creating marine reserves, putting pressure on the fishing industry to reduce capacity, and persuading consumers to eat only sustainable fish. The film’s website provides links to campaigning organisations such as Greenpeace and the Monterey Bay Aquarium in California. “We plan to go from city to city with our campaign,” says Mr Murray. “A massive outreach was part of our intention with this film from the start.”

Gaston Lenôtre

Jan 22nd 2009
From The Economist print edition

Gaston-Albert-Célestin Lenôtre, king of patissiers, died on January 8th, aged 88

Lenotre



IMAGINE a macaroon, its pink surface smooth and delicate as paper, crushing through into a soft crumb perfumed with rose petals. Or a croissant, crisp as thin caramel on the outside, breaking into slightly gluey, buttery white flakes. Or a dome of the bitterest dark chocolate, giving way to a silky chocolate ganache, subsiding into a hollow of crème brûlée infused with aromas of green tea.

Gaston Lenôtre thought of such things all the time. They accounted for his radiant, almost constant smile, and his cry of "Allez-y, les enfants!" when encouraging his chefs. And yet he was not just having fun. Pastry-making, he insisted, was a science closely akin to mathematics. It required exact weights, exact times, exact proportions (*tant pour tant*, in the language of his kitchen-laboratory), focus and iron discipline. Sheer *rigueur* had put him at the top of France's pastry tree, beside Carême and within a whisk-beat of the great Escoffier.

The elements of his craft seemed simple enough, when laid out on the page:

> Three eggs
> 1 cupful caster sugar
> One ½ stick unsalted butter

But in Mr Lenôtre's world the eggs were laid that morning, fresh out of the straw and kept for half an hour at room temperature. The butter (and cream) came from a dappled and contented cow, grazing under an apple tree in his native Normandy. Egg-yolks were to be beaten until an egg-ribbon, trickled over the pale yellow surface, took five seconds to dissolve. Sponge fingers had to be baked until they were just springy to the touch, and not a moment more. Butter, melted for *crêpes*, was ready when it gave off a "slightly nutty smell". And this was all before the tricky stuff, when chocolate was cut into fans with a fine-bladed knife, or the final swirl of mango *coulis* was licked on with a paintbrush.

A dish of rice pudding

Food of all kinds he loved and lavished. At the banquets he organised at the Elysée Palace or Versailles—

for he was also, from the 1960s, a caterer in the grand style, happily feeding thousands—peacocks of Parma ham stood on the tables, alongside whole stuffed pigs. His base in Yvelines, a suburb of Paris, was an industrial-sized site incorporating a school where, on any day, 400 working chefs would be retraining in every branch of cookery. But *patisserie-boulangerie* was his passion. Visiting Paris as a hungry teenager, his chief impression was of bread: "good bread, real bread".

His first sweet creation, a rice pudding, had been offered to his discerning chef-parents when he was 12. Pocket money came from making *batonnets glacés* for patrons of the Bernay cinema. There followed a brief apprenticeship at a baker's in Pont Audemer, sufficient to show him that making *étouffe-chrétien* brioches and madeleines was not the way forward. Ten years later, in 1947, he bought the shop and filled it with delectables; ten years after that—for it took ten years of practice, he claimed, to make a decent chef—he opened in the rue d'Auteuil in Paris, where the ventilation ducts carefully piped the scent of *pains chocolats* out into the street.

Huge fame followed. By 1976 Mr Lenôtre had acquired Le Pré Catalan in the Bois de Boulogne, a restaurant with 12 reception rooms. By this year his brand brought in $162m and had 53 boutiques across the world, where $50 would buy you a Lenôtre box of chocolates with a recipe and an apron, and individual *bouchées* came cased in Limoges porcelain. Maison Lenôtre was always a family affair, with wives and children helping and his chef-students happily supporting. His 80th birthday party, a grand picnic in the middle of the Champ de Mars, featured a cake depicting scenes from his life: a ten-metre tower of ganache and meringue decked in blown sugar, spun sugar and royal icing.

He was often mentioned in the same breath as his friends Paul Bocuse and Roger Vergé, as a *nouvelle cuisine* man. Certainly lightness was his watchword. Flour featured as little as possible in his recipes, and sugar was rationed. Whiskings went on to the point of foaming or voluminousness, and the word "gently" featured often, keeping the airiness in. Rivalry whirled round his wildly fashionable, featherlight, multicoloured and multiflavoured macaroons; if Mr Lenôtre was not their inventor, he still named his house Villa Macaron after them. He made square ones, too.

Yet he was also a Norman and proud of it, the son of a cuisine flowing with butter, cream and cheese. He could never renounce them. Butter featured in his books by the chunk and the double-tablespoon. Cream was unctuously ever-present. He always said he abjured *crème patissière* as hotly as he did margarine; yet the vanilla cream he devised as a replacement began with three egg yolks, beaten with sugar, and went deliciously downhill from there.

In his 80s he kept his generosity, his curiosity and his appetite. The day began with a couple of well-buttered *tartines*, and in the course of it he might well get a *millefeuille* ready. At Pont Audemer he had made them three times a day, to be sure they were fresh. They had to be taken from the oven, he advised, when the puff pastry was "just a little more than golden brown".

How fitting, said a chef friend, but how sad, that he died just as he should have been enjoying a fine *galette des rois*.



Overview

Jan 22nd 2009
From The Economist print edition

China's GDP is growing at its slowest in seven years. In the year to the fourth quarter it rose by 6.8%, compared with 9% in the third.

Consumer prices in **America** fell by 0.7% in December, following a 1.7% drop in November. The annual rate of inflation fell to 0.1%. The prices of goods other than food and energy were unchanged in November; the core inflation rate was 1.8%.

The **euro-area** economy will shrink by 1.9% this year, according to new forecasts by the European Commission. GDP is expected to fall by 2.3% in Germany, by 1.8% in France, and by 2% in Spain and Italy. The worst-hit economy is likely to be Ireland's, with a 5% fall in output. The commission reckons the combined budget deficit of euro-area countries will rise to 4% of GDP this year. The unemployment rate may top 10% by 2010.

In **Britain** the unemployment rate rose to 6.1% in the three months to November, from 5.7% in the previous three months. A timelier measure of unemployment, based on benefit claims, rose by 77,900 in December, beating 1991's peak for a second consecutive month. Consumer-price inflation fell from 4.1% to 3.1% in December, partly thanks to a cut in value-added taxes.

Brazil's central bank cut its benchmark interest rate by one percentage point, to 12.75%, on January 21st. A day earlier the Bank of **Canada** reduced its main rate, from 1.5% to 1%. In **Hungary** the central bank trimmed its base rate by half a percentage point, to 9.5%.



Output, prices and jobs

Jan 22nd 2009
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2008†	2009†	latest	latest	year ago	2008†	rate‡, %
United States	+0.7 Q3	−0.5	+0.9	−1.2	−7.8 Dec	+0.1 Dec	+4.1	+3.7	7.2 Dec
Japan	−0.5 Q3	−1.8	nil	−1.4	−16.2 Nov	+1.0 Nov	+0.6	+1.5	3.9 Nov
China	+6.8 Q4	na	+9.1	+6.0	+5.7 Dec	+1.2 Dec	+6.5	+5.9	9.0 2008
Britain	+0.3 Q3	−2.0	+0.6	−1.7	−6.9 Nov	+3.1 Dec§	+2.1	+3.5	6.1 Nov††
Canada	+0.5 Q3	+1.3	+0.4	nil	−3.4 Oct	+2.0 Nov	+2.5	+2.2	6.6 Dec
Euro area	+0.6 Q3	−0.7	+0.7	−1.4	−7.7 Nov	+1.6 Dec	+3.1	+3.2	7.8 Nov
Austria	+1.5 Q3	+0.6	+1.6	−1.3	−2.7 Oct	+1.3 Dec	+3.6	+3.0	3.8 Nov
Belgium	+1.3 Q3	+0.4	+1.3	−0.7	−5.3 Oct	+2.6 Dec	+3.1	+4.4	10.8 Dec‡‡
France	+0.5 Q3	+0.5	+0.7	−1.0	−9.0 Nov	+1.0 Dec	+2.6	+3.0	7.9 Nov
Germany	+0.8 Q3	−2.1	+1.0	−1.4	−6.3 Nov	+1.1 Dec	+3.1	+2.6	7.6 Dec
Greece	+3.1 Q3	+2.0	+2.6	+1.4	−5.9 Nov	+2.0 Dec	+3.9	+4.0	7.4 Sep
Italy	−0.9 Q3	−2.1	−0.5	−1.2	−9.7 Dec	+2.2 Dec	+2.6	+3.4	6.7 Q3
Netherlands	+1.8 Q3	+0.1	+1.6	−0.6	−6.2 Nov	+1.9 Dec	+1.9	+2.3	3.9 Dec††
Spain	+0.9 Q3	−0.9	+1.0	−1.3	−17.2 Nov	+1.4 Dec	+4.2	+4.3	13.4 Nov
Czech Republic	+4.2 Q3	+3.8	+4.2	+0.8	−17.4 Nov	+3.6 Dec	+5.4	+6.5	6.0 Dec
Denmark	−1.2 Q3	−1.9	−0.4	−1.2	−6.8 Nov	+2.4 Dec	+2.3	+3.4	1.9 Nov
Hungary	+0.8 Q3	−0.3	+1.2	−1.5	−12.0 Nov	+3.5 Dec	+7.4	+6.3	7.8 Nov††
Norway	+0.6 Q3	−2.8	+1.8	−0.2	+0.1 Nov	+2.1 Dec	+2.8	+3.8	2.7 Oct***
Poland	+4.8 Q3	na	+5.1	+2.9	−4.4 Dec	+3.3 Dec	+4.0	+4.3	9.1 Nov‡‡
Russia	+6.2 Q3	na	+7.0	+3.7	−8.7 Nov	+13.3 Dec	+11.9	+14.1	6.6 Nov‡‡
Sweden	nil Q3	−0.4	+0.6	−0.6	−11.9 Nov	+0.9 Dec	+3.5	+3.4	6.4 Dec‡‡
Switzerland	+1.7 Q3	+0.1	+1.6	−0.6	+0.7 Q3	+0.7 Dec	+2.0	+2.4	2.8 Dec
Turkey	+0.5 Q3	na	+2.5	+1.5	−13.9 Nov	+10.1 Dec	+8.4	+10.5	10.3 Q3‡‡
Australia	+1.9 Q3	+0.3	+2.0	+0.8	+3.8 Q3	+5.0 Q3	+1.9	+4.4	4.5 Dec
Hong Kong	+1.7 Q3	−2.0	+3.1	−1.0	−6.7 Q3	+2.1 Dec	+3.8	+4.2	4.1 Dec††
India	+7.6 Q3	na	+6.2	+6.1	+2.4 Nov	+10.4 Nov	+5.5	+8.1	6.8 2008
Indonesia	+6.1 Q3	na	+6.1	+3.5	+1.9 Nov	+11.1 Dec	+4.9	+10.4	8.4 Aug
Malaysia	+4.7 Q3	na	+5.6	+3.2	−7.7 Nov	+4.4 Dec	+2.4	+5.7	3.1 Q3
Pakistan	+5.8 2008**	na	+6.0	+1.4	−2.2 Oct	+23.3 Dec	+8.8	+20.8	5.6 2007
Singapore	−2.6 Q4	−12.5	+2.2	−2.2	−7.5 Nov	+4.3 Dec	+4.4	+6.6	2.2 Q3
South Korea	−3.4 Q4	−20.8	+4.2	−1.7	−14.1 Nov	+4.1 Dec	+3.6	+4.9	3.3 Dec
Taiwan	−1.0 Q3	na	+2.3	−2.9	−28.4 Nov	+1.2 Dec	+3.3	+3.8	5.0 Dec
Thailand	+4.0 Q3	+2.3	+4.0	+1.9	−6.6 Nov	+0.4 Dec	+3.2	+5.8	1.1 Sep
Argentina	+6.2 Q3	+5.4	+6.2	+2.2	−7.2 Nov	+7.2 Dec	+8.5	+8.8	7.8 Q3‡‡
Brazil	+6.8 Q3	+7.4	+5.3	+2.4	−6.2 Nov	+5.9 Dec	+4.5	+5.8	7.6 Nov‡‡
Chile	+4.8 Q3	−0.2	+3.9	+1.0	−5.7 Nov	+7.1 Dec	+7.8	+8.9	7.5 Nov††‡‡
Colombia	+3.1 Q3	+2.9	+3.2	+2.0	−13.3 Nov	+7.7 Dec	+5.7	+7.1	10.8 Nov‡‡
Mexico	+1.6 Q3	+2.6	+1.8	−0.2	−2.7 Oct	+6.5 Dec	+3.8	+5.2	4.3 Dec‡‡
Venezuela	+4.6 Q3	na	+4.2	−3.0	+2.7 Sep	+30.9 Dec	+22.4	+30.5	7.2 Q3‡‡
Egypt	+5.9 Q3	na	+7.2	+5.1	+6.8 Q2	+18.3 Dec	+6.9	+18.4	8.6 Q3‡‡
Israel	+5.1 Q3	+2.3	+4.2	+1.8	+1.8 Oct	+3.8 Dec	+3.4	+4.7	5.9 Q3
Saudi Arabia	+3.5 2007	na	+6.0	+3.0	na	+9.5 Nov	+4.8	+9.4	na
South Africa	+2.9 Q3	+0.2	+3.5	+2.5	−4.4 Nov	+11.8 Nov	+8.4	+11.4	23.2 Sep‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	−3.5 Q3	na	−2.0	−2.5	−17.7 Nov	+7.0 Dec	+9.6	+10.4	7.5 Oct
Finland	+1.3 Q3	+0.4	+1.6	−0.7	−10.1 Nov	+3.5 Dec	+2.6	+3.9	6.6 Dec
Iceland	−0.8 Q3	−5.5	−0.5	−9.7	+0.4 2007	+18.1 Dec	+5.9	+13.8	3.3 Nov‡‡
Ireland	+0.1 Q3	+4.7	−2.5	−2.9	+2.8 Nov	+1.1 Dec	+4.7	+4.2	8.3 Dec
Latvia	−4.6 Q3	na	−1.5	−7.0	−13.9 Nov	+10.5 Dec	+14.1	+15.7	7.2 Oct
Lithuania	+2.9 Q3	+1.6	+4.4	+1.6	na	+8.5 Dec	+8.1	+11.2	5.7 Dec‡‡
Luxembourg	+2.8 Q2	+4.5	+2.5	+1.5	−13.1 Oct	+1.1 Dec	+3.4	+3.6	4.7 Nov‡‡
New Zealand	−1.4 Q3	−2.7	+0.3	+1.1	+2.4 Q2	+3.4 Q4	+3.2	+4.3	4.2 Q3
Peru	+5.1 Nov	na	+9.1	+5.5	+3.6 Oct	+6.7 Dec	+3.9	+5.8	7.9 Nov‡‡
Philippines	+4.6 Q3	+3.4	+4.2	+1.8	+2.2 Oct	+8.0 Dec	+3.9	+9.6	6.8 Q4‡‡
Portugal	+0.6 Q3	−0.5	+0.4	−0.8	−3.0 Oct	+0.8 Dec	+2.7	+2.6	7.7 Q3‡‡
Slovakia	+7.0 Q3	na	+6.8	+3.3	−7.1 Nov	+4.4 Dec	+3.4	+4.6	8.4 Dec‡‡
Slovenia	+3.8 Q3	na	+4.2	+2.0	−12.0 Nov	+2.1 Dec	+5.6	+5.7	6.7 Nov‡‡

*% change on previous quarter, annual rate. †*The Economist* poll or Economist Intelligence Unit estimate/forecast. ‡National definitions.- §RPI inflation rate 0.9% in Dec. **Year ending June. ††Latest three months. ‡‡Not seasonally adjusted. ***Centred 3-month average

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

The Economist commodity-price index

Jan 22nd 2009
From The Economist print edition

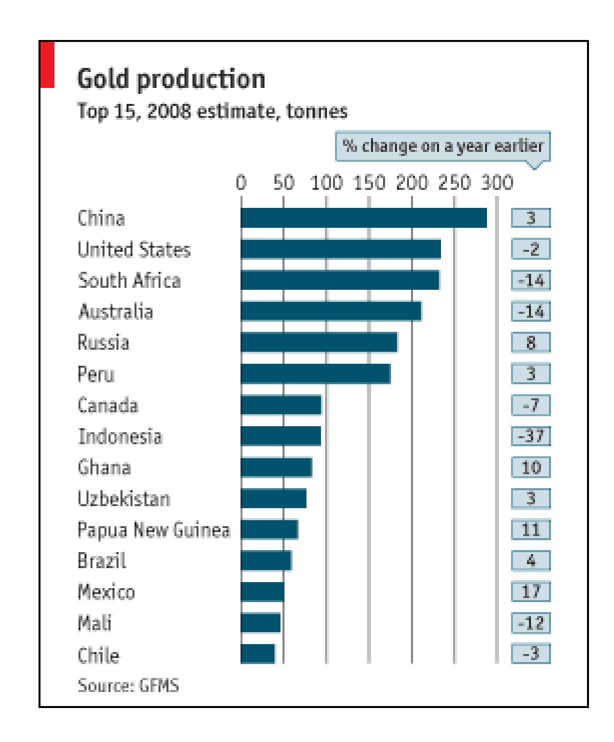
The Economist commodity-price index
2000=100

	Jan 13th	Jan 20th*	% change on one month	% change on one year
Dollar index				
All items	157.0	158.8	+3.2	-29.7
Food	184.9	187.7	+3.1	-17.2
Industrials				
All	121.1	121.3	+3.3	-46.0
Nfa†	113.1	113.8	+1.7	-37.3
Metals	125.4	125.4	+4.1	-49.5
Sterling index				
All items	163.6	172.4	+8.6	-1.4
Euro index				
All items	110.2	113.7	+11.4	-20.5
Gold				
$ per oz	822.85	862.10	+2.6	-3.4
West Texas Intermediate				
$ per barrel	38.50	38.53	-1.5	-57.0

*Provisional †Non-food agriculturals.

Gold production

Jan 22nd 2009
From The Economist print edition



The output of the world's gold mines fell by 4% last year, according to estimates in a new report from the GFMS, a consultancy. More than half the 88-tonne fall in production was accounted for by a slump in gold mining in Indonesia. Supply from South Africa, once the world's largest producer, fell by 14%—the biggest drop since the Boer War. Last year's fall was partly owing to new safety procedures, which helped reduce the industry's fatality rate. Skills shortages and power cuts also affected operations. Australia's output fell by 14%, too, amid reports that some fledgling mining firms faced closure because of scarce credit. Of the world's six big producers, China, Russia and Peru all increased output last year.



Trade, exchange rates, budget balances and interest rates

Jan 22nd 2009
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance* latest 12 months, $bn	Current-account balance latest 12 months, $bn	Current-account balance % of GDP 2008†	Currency units, per $ Jan 21st	Currency units, per $ year ago	Budget balance % of GDP 2008†	Interest rates, % 3-month latest	Interest rates, % 10-year gov't bonds, latest
United States	−833.1 Nov	−697.9 Q3	−4.5	–	–	−3.2	0.29	2.52
Japan	+47.3 Nov	+167.1 Nov	+3.8	87.6	106	−3.3	0.61	1.23
China	+295.1 Dec	+371.8 2007	+10.2	6.84	7.23	−0.1	1.41	3.01
Britain	−178.6 Nov	−45.6 Q3	−2.4	0.73	0.51	−5.3	2.13	3.66
Canada	+47.3 Nov	+19.2 Q3	+1.0	1.27	1.03	0.2	0.85	2.97
Euro area	−52.0 Nov	−61.5 Oct	−0.3	0.78	0.69	−1.6	2.31	2.99
Austria	−0.6 Oct	+16.8 Q3	+2.8	0.78	0.69	−1.0	2.31	3.96
Belgium	+7.9 Sep	−8.2 Sep	+0.1	0.78	0.69	−0.8	2.34	4.14
France	−83.3 Nov	−58.7 Nov	−1.8	0.78	0.69	−3.0	2.31	3.56
Germany	+267.2 Nov	+244.3 Nov	+6.6	0.78	0.69	0.3	2.31	2.99
Greece	−68.5 Oct	−53.3 Oct	−10.3	0.78	0.69	−3.2	2.31	5.76
Italy	−18.7 Nov	−72.2 Oct	−2.9	0.78	0.69	−2.6	2.31	4.48
Netherlands	+55.4 Nov	+67.6 Q3	+6.7	0.78	0.69	1.1	2.31	3.78
Spain	−149.5 Oct	−164.1 Oct	−9.8	0.78	0.69	−3.3	2.31	4.23
Czech Republic	+4.8 Nov	−6.6 Nov	−2.9	21.4	17.9	−1.9	2.95	3.84
Denmark	+6.2 Nov	+6.3 Nov	+1.1	5.79	5.12	3.9	6.75	3.41
Hungary	−0.1 Nov	−11.3 Q3	−5.0	221	178	−3.4	9.47	8.70
Norway	+78.9 Dec	+86.5 Q3	+18.4	6.99	5.56	19.7	3.52	3.57
Poland	−24.0 Nov	−29.4 Nov	−5.6	3.37	2.50	−1.8	5.51	5.28
Russia	+189.4 Nov	+98.9 Q4	+6.0	32.8	24.7	5.8	13.00	11.28
Sweden	+17.7 Nov	+40.5 Q3	+7.3	8.37	6.54	2.4	1.20	2.75
Switzerland	+18.2 Nov	+40.3 Q3	+9.1	1.15	1.09	0.9	0.54	2.06
Turkey	−72.7 Nov	−43.9 Nov	−6.4	1.66	1.20	−1.6	14.94	7.79‡
Australia	−5.0 Nov	−56.7 Q3	−4.8	1.54	1.16	−0.3	3.61	4.08
Hong Kong	−28.0 Nov	+27.1 Q3	+9.4	7.76	7.81	−3.9	0.90	1.30
India	−112.3 Nov	−28.5 Q3	−3.6	49.1	39.6	−4.3	4.57	6.65
Indonesia	+12.1 Nov	+3.9 Q3	+0.4	11,200	9,390	−1.4	11.13	10.83‡
Malaysia	+42.2 Nov	+38.3 Q3	+12.8	3.62	3.28	−5.0	3.25	3.91‡
Pakistan	−21.8 Dec	−14.0 Q2	−5.7	79.7	62.4	−6.8	14.76	24.77‡
Singapore	+18.4 Dec	+29.2 Q3	+16.6	1.51	1.43	0.8	0.56	1.62
South Korea	−14.2 Dec	−7.9 Nov	−2.2	1,374	953	1.1	2.97	4.55
Taiwan	+3.9 Dec	+28.8 Q3	+6.4	33.6	32.4	−1.6	1.15	1.45
Thailand	−1.3 Nov	−0.6 Nov	−1.0	34.9	33.1	−1.4	3.85	2.82
Argentina	+14.1 Nov	+9.0 Q3	+2.7	3.47	3.16	0.7	18.19	na
Brazil	+24.7 Dec	−26.3 Nov	−1.8	2.36	1.81	−1.5	13.65	6.16‡
Chile	+10.2 Dec	−1.6 Q3	−2.6	626	478	5.9	7.32	3.78‡
Colombia	+2.7 Oct	−5.3 Q3	−2.4	2,246	1,996	−1.0	9.62	7.25‡
Mexico	−14.5 Nov	−11.8 Q3	−1.7	14.0	11.0	nil	7.44	7.45
Venezuela	+50.2 Q3	+49.4 Q3	+15.5	5.40	5.25§	−1.1	17.13	6.55‡
Egypt	−25.2 Q3	+0.1 Q3	+0.8	5.55	5.54	−6.8	11.35	4.66‡
Israel	−13.7 Dec	+2.6 Q3	+1.3	3.93	3.68	−0.7	1.36	3.52
Saudi Arabia	+150.8 2007	+95.0 2007	+30.3	3.75	3.75	10.7	1.34	na
South Africa	−10.6 Nov	−23.2 Q3	−7.8	10.2	7.11	0.2	11.33	7.84
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*								
Estonia	−4.0 Oct	−2.5 Nov	−11.9	12.1	10.7	−1.0	7.27	na
Finland	+10.2 Nov	+6.8 Nov	+3.8	0.78	0.69	4.5	2.27	3.85
Iceland	−0.3 Dec	−5.4 Q3	−17.3	129	67.0	0.3	18.27	na
Ireland	+40.7 Oct	−16.4 Q3	−2.6	0.78	0.69	−6.5	2.31	5.65
Latvia	−5.9 Nov	−4.8 Nov	−14.2	0.55	0.48	−2.0	9.24	na
Lithuania	−7.3 Nov	−6.4 Nov	−13.9	2.68	2.37	−0.9	8.42	na
Luxembourg	−7.5 Oct	+4.0 Q3	na	0.78	0.69	0.3	2.31	na
New Zealand	−3.5 Nov	−11.6 Q3	−7.1	1.92	1.32	0.3	4.65	4.34
Peru	+4.0 Nov	−3.0 Q3	−2.8	3.15	2.95	2.7	6.50	na
Philippines	−8.7 Oct	+2.9 Sep	+1.8	47.5	41.3	−0.9	4.94	na
Portugal	−34.3 Oct	−29.3 Oct	−9.7	0.78	0.69	−2.4	2.31	4.46
Slovakia	−1.2 Nov	−6.7 Sep	−6.0	23.4	23.3	−2.3	1.35	4.01
Slovenia	−4.7 Nov	−3.4 Oct	−6.6	0.78	0.69	0.4	2.31	na

*Merchandise trade only. †*The Economist* poll or Economist Intelligence Unit forecast. ‡Dollar-denominated bonds. §Unofficial exchange rate.
Sources: National statistics offices and central banks; Thomson Datastream; Reuters; JPMorgan; Bank Leumi le-Israel; Centre for Monitoring Indian Economy; Danske Bank; Hong Kong Monetary Authority; Standard Bank Group; UBS; Westpac.



Markets

Jan 22nd 2009
From The Economist print edition

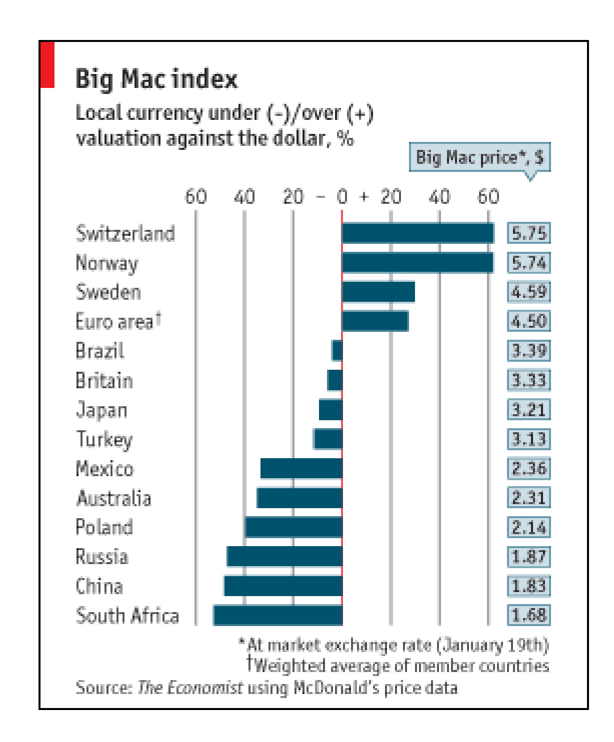
Markets

	Index Jan 21st	% change on one week	% change on Dec 31st 2007 in local currency	% change on Dec 31st 2007 in $ terms
United States (DJIA)	8,228.1	+0.3	-38.0	-38.0
United States (S&P 500)	840.2	-0.3	-42.8	-42.8
United States (NAScomp)	1,507.1	+1.2	-43.2	-43.2
Japan (Nikkei 225)	7,901.6	-6.4	-48.4	-34.2
Japan (Topix)	787.2	-3.9	-46.7	-32.0
China (SSEA)	2,084.2	+2.9	-62.3	-59.7
China (SSEB, $ terms)	121.5	+1.1	-68.9	-66.8
Britain (FTSE 100)	4,059.9	-2.9	-37.1	-56.6
Canada (S&P TSX)	8,757.9	+0.8	-36.7	-50.9
Euro area (FTSE Euro 100)	668.7	-4.6	-51.4	-57.2
Euro area (DJ STOXX 50)	2,188.4	-4.8	-50.3	-56.2
Austria (ATX)	1,612.7	-3.8	-64.3	-68.5
Belgium (Bel 20)	1,795.0	-5.0	-56.5	-61.7
France (CAC 40)	2,905.6	-4.8	-48.2	-54.4
Germany (DAX)*	4,261.2	-3.6	-47.2	-53.5
Greece (Athex Comp)	1,702.7	-2.3	-67.1	-71.0
Italy (S&P/MIB)	17,684.0	-5.8	-54.1	-59.6
Netherlands (AEX)	237.7	-3.9	-53.9	-59.4
Spain (Madrid SE)	870.6	-5.6	-47.0	-53.3
Czech Republic (PX)	784.4	-6.5	-56.8	-63.3
Denmark (OMXCB)	232.0	-0.1	-48.3	-54.4
Hungary (BUX)	11,842.6	-5.1	-54.9	-64.7
Norway (OSEAX)	271.3	+2.0	-52.4	-63.0
Poland (WIG)	25,628.8	-2.3	-53.9	-66.4
Russia (RTS, $ terms)	530.1	-10.4	-69.1	-76.9
Sweden (Aff.Gen)	184.7	-1.9	-45.7	-58.1
Switzerland (SMI)	5,304.2	-1.4	-37.5	-38.3
Turkey (ISE)	24,736.1	-1.3	-55.5	-68.6
Australia (All Ord.)	3,394.8	-6.3	-47.1	-59.9
Hong Kong (Hang Seng)	12,583.6	-8.2	-54.8	-54.5
India (BSE)	8,779.2	-6.3	-56.7	-65.3
Indonesia (JSX)	1,321.5	-4.7	-51.9	-59.6
Malaysia (KLSE)	873.4	-4.4	-39.6	-44.7
Pakistan (KSE)	5,136.5	-15.1	-63.5	-71.8
Singapore (STI)	1,704.5	-3.4	-50.8	-53.0
South Korea (KOSPI)	1,103.6	-6.7	-41.8	-60.4
Taiwan (TWI)	4,248.0	-6.0	-50.1	-51.8
Thailand (SET)	431.2	-1.9	-49.7	-51.6
Argentina (MERV)	1,062.7	-2.3	-50.6	-55.2
Brazil (BVSP)	38,542.0	+1.5	-39.7	-54.5
Chile (IGPA)	11,781.7	+0.9	-16.3	-33.4
Colombia (IGBC)	7,468.3	-1.9	-30.2	-37.3
Mexico (IPC)	19,497.1	-4.3	-34.0	-48.4
Venezuela (IBC)	35,306.0	+0.9	-6.9	-63.0
Egypt (Case 30)	3,780.4	-15.6	-63.9	-64.1
Israel (TA-100)	583.0	-0.3	-49.5	-50.5
Saudi Arabia (Tadawul)	4,556.8	-7.7	-58.7	-58.7
South Africa (JSE AS)	20,049.0	-3.8	-30.8	-53.6
Europe (FTSEurofirst 300)	769.2	-4.4	-48.9	-55.0
World, dev'd (MSCI)	838.4	-2.8	-47.2	-47.2
Emerging markets (MSCI)	515.2	-5.1	-58.6	-58.6
World, all (MSCI)	207.4	-3.0	-48.6	-48.6
World bonds (Citigroup)	784.7	-1.4	+7.4	+7.4
EMBI+ (JPMorgan)	388.7	-0.8	-10.4	-10.4
Hedge funds (HFRX)‡	1,031.2	+0.1	-22.5	-22.5
Volatility, US (VIX)	46.4	49.1	22.5	(levels)
CDSs, Eur (iTRAXX)†	172.8	-0.4	+241.5	+200.7
CDSs, N Am (CDX)†	236.8	-0.5	+204.0	+204.0
Carbon trading (EU ETS) €	11.6	-13.2	-49.1	-55.2

*Total return index. †Credit-default swap spreads, basis points.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CMIE; Danske Bank; EEX; HKMA; Markit; Standard Bank Group; UBS; Westpac. ‡Dec 31st.

Big Mac index

Jan 22nd 2009
From The Economist print edition



The dollar's recent revival has made fewer currencies look dear against the Big Mac index, our lighthearted guide to exchange rates. The index is based on the idea of purchasing-power parity, which says currencies should trade at the rate that makes the price of goods the same in each country. So if the price of a Big Mac translated into dollars is above $3.54, its cost in America, the currency is dear; if it is below that benchmark, it is cheap. There are three noteworthy shifts since the summer. The yen, which had looked very cheap, is now close to fair value. So is the pound, which had looked dear the last time we compared burger prices in July. The euro is still overvalued on the burger gauge, but far less so than last summer.